STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company	**:**	
d/b/a Nicor Gas Company	**:**	
	:	**04-0779**
Proposed general increase in natural gas	**:**	
rates. (Tariffs filed on November 4, 2004)	**:**	

<u>ADMINISTRATIVE LAW JUDGES' PROPOSED ORDER</u>

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By the Commission:

I. INTRODUCTION

Procedural History

On November 4, 2004, Northern Illinois Gas Company, doing business as Nicor Gas Company ("Nicor Gas" or "Nicor" or the "Company"), filed with the Illinois Commerce Commission ("Commission") pursuant to Section 9-201 of the Public Utilities Act ("Act") (220 ILCS 5/9-201) the following tariff sheets: Ill. C. C. No. 16, 13th Revised Sheet No. 1; 2nd Revised Sheet Nos. 2 through 13; 2nd Revised Sheet Nos. 15 and 16; 1st Revised Sheet No. 17.51; Original Sheet No. 17.51.1; 1st Revised Sheet Nos. 17.52 through 17.55; 4th Revised Sheet No. 18; 2nd Revised Sheet No. 19; 4th Revised Sheet Nos. 21, 22 and 24; 1st Revised Sheet No. 24.5; 4th Revised Sheet No. 25; 3rd Revised Sheet Nos. 26 and 27; 4th Revised Sheet No. 28; 3rd Revised Sheet Nos. 29 and 30; 4th Revised Sheet Nos. 31 and 32; 3rd Revised Sheet No. 33; 2nd Revised Sheet No. 35; 4th Revised Sheet Nos. 36 and 39; 2nd Revised Sheet Nos. 39.5, 41 and 44; 3rd Revised Sheet No. 46; 6th Revised Sheet No. 48; 4th Revised Sheet Nos. 49 and 50; Original Sheet No. 50.1; 4th Revised Sheet No. 51; 5th Revised Sheet No. 52; 2nd Revised Sheet Nos. 52.5, 56 and 57; 5th Revised Sheet Nos. 58 and 60; 3rd Revised Sheet No. 63; Original Sheet No. 63.5; 3rd Revised Sheet No. 64; 2nd Revised Sheet Nos. 65, 66, 68 and 70; 3rd Revised Sheet No. 71; 2nd Revised Sheet No. 72; 7th Revised Sheet No. 75.1; 5th Revised Sheet No. 75.2; 7th Revised Sheet No. 75.3; 6th Revised Sheet Nos. 75.4 through 75.8; 4th Revised Sheet No. 76; and 3rd Revised Sheet Nos. 77 and 78. This rate filing embodied a general increase in rates for natural gas service as well as other proposed changes in terms and conditions. Notice of the proposed changes reflected in this rate filing was posted in Nicor Gas' business offices and published in a newspaper of general circulation in Nicor Gas' service area, as evidenced by publisher's certificates, in accordance with the requirements of Section 9-201(a) of the Public Utilities Act (the "Act"), 220 ILCS 5/9-201(a), and the provisions of 83 Ill. Adm. Code Part 255. The Commission issued an Order on December 15, 2004, suspending the tariffs to and including April 2, 2005, and initiating this proceeding. Subsequently, the Commission resuspended the tariffs to and including October 2, 2005.

Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter was heard by duly authorized Administrative Law Judges at the offices of the Commission in Chicago, Illinois. Status hearings were held on January 4, March 7, May 10, and May 18, 2005.

Petitions to Intervene were filed on behalf of the People of the State of Illinois (the "Attorney General" or the "AG"); Business Energy Alliance and Resources L.L.C. ("BEAR"); the Citizens Utility Board ("CUB"); Constellation NewEnergy - Gas Division, LLC ("CNE"); the Cook County State's Attorney's Office ("CCSAO"); Dominion Retail, Inc. ("Dominion"); the Environmental Law & Policy Center ("ELPC"); BP Corporation, Cargill, Inc., Caterpillar Inc., Citgo Petroleum Corporation, Cognis Corporation, ExxonMobil Oil Corporation, Ford Motor Company, Hormel Foods Service Corporate Services, LLC., International Steel Group, and U.S. Silica Company (collectively the "Illinois Industrial Energy Consumers" or "IIEC"); Nucor Steel Kankakee, Inc.; Peoples Energy Services Corporation; Direct Energy Services LLC, Interstate Gas Supply of Illinois, Inc., MidAmerican Energy Company, U.S. Energy Savings Corporation, and WPS Energy Services, Inc. (collectively the "Retail Gas Suppliers" or "RGS"); and Vanguard Energy Services, LLC ("Vanguard"). These Petitions all were granted by the ALJs.

Evidentiary hearings were held from May 19-27, 2005. At the evidentiary hearings, Nicor Gas, the Staff of the Commission ("Staff"), the AG, BEAR, CUB/CCSAO (jointly), CNE, CNE/IIEC (jointly), Dominion, the ELPC, the IIEC, RGS, and Vanguard entered appearances and presented testimony. At the conclusion of the hearings, on May 27, 2005, the record was marked "Heard and Taken."

The following witnesses testified on behalf of Nicor Gas: Richard L. Hawley, CPA, Executive Vice President and Chief Financial Officer; Gerald P. O'Connor, FCCA (Chartered Certified Accountant in Ireland and the United Kingdom), Vice President, Finance and Administration; Kenneth Gordon, Ph.D, Special Consultant, National Economic Research Associates, Inc.; Robert R. Mudra, CFA, now Director, Rates and Financial Analysis; Jeff D. Makholm, Ph.D, Senior Vice President, National Economic Research Associates, Inc.; Rocco J. D'Alessandro, Senior Vice President, Operations; Anthony McCain, Vice President, Distribution; Christine L. Suppes, Vice President, Sales and Customer Care; Gary R. Bartlett, P.E., Vice President, Supply Operations; Rebecca C. Bacidore, Assistant Vice President, Human Resources; John Madziarczyk, General Manager, Procurement Operations; James M. Gorenz, CPA, Manager of Supply Accounting; Albert E. Harms, formerly, Manager, Rate Research, and currently a Consultant for Nicor Gas; Hethie S. Parmesano, Ph.D, Vice President, National Economic Research Associates, Inc.; Alan C. Heintz, Vice President, Brown, Williams, Moorhead & Quinn, Inc; Cesar A. Herrera, Ph.D, Senior Consultant, National Economic Research Associates, Inc.; Eugene S. Takle, Ph.D, CCM (Certified Consulting Meteorologist); Myra Karegianes, Partner, Karegianes & Field, LLC; and Val R. Jensen, Senior Vice President, ICS Consulting.

The following witnesses testified on behalf of the Staff: Scott A. Struck, CPA, Supervisor of the Accounting Department, Financial Analysis Division; Theresa Ebrey, CPA, Leslie Pugh, CPA, and Thomas L. Griffin, all Accountants in the Accounting Department, Financial Analysis Division; Michael McNally, Senior Financial Analyst, Finance Department, Financial Analysis Division; Mark Maple, Gas Engineer, Engineering Department, Energy Division; Mike Luth, CPA, Accountant, Rates Department, Financial Analysis Division; David A. Borden, Economic Analyst, Energy Division; and Gene Beyer, Chief, Public Utilities Bureau.

CUB and CCSAO ("CUB/CCSAO") presented as joint witnesses Christopher C. Thomas, Senior Policy Analyst for CUB, and Jerome D. Mierzwa, Principal and Vice President, Exeter Associates, Inc. The AG's witness was David J. Effron, CPA, Consultant. ELPC's witness was Martin G. Kushler, Ph.D, Director, Utilities Program, American Council for an Energy-Efficient Economy.

CNE's witness was John M. Oroni, Regional Sales Director. CNE and IIEC jointly submitted testimony by Alan Rosenberg, Ph.D, Consultant, Brubaker & Associates, Inc. Dominion's witness was James L. Crist, President, Lumen Group, Inc. RGS' witness was Scott White, President, Interstate Gas Supply of Illinois, Inc. Vanguard's witness was Neil Anderson, Partner.

IIEC submitted testimony of Dr. Rosenberg, which was separate from the joint testimony for the same witness that IIEC and CNE submitted. BEAR's witness was B.J. Hilton, one of BEAR's founders.

Nature of Operations

Nicor Gas provides natural gas service to customers in a service territory of approximately 17,000 square miles that includes much of north and north-central Illinois, excluding the City of Chicago and certain suburbs served by affiliates of Peoples Energy. By the end of the 2005 test year, Nicor Gas expects to be serving approximately 2,140,000 customers, of which approximately 1,950,000 will be residential users, and approximately 190,000 will be commercial, industrial, and other non-residential users. Nicor Gas provides sales service (i.e., service that involves both the transportation of gas to the end user and the sale of gas itself) and transportation services (i.e., service that principally involves the movement and delivery of gas and, only incidentally if at all, the sale of gas itself). To serve those customers and provide those services, Nicor Gas operates and maintains eight aquifer gas storage fields, which provide supply flexibility and certainty, improve the reliability of deliveries, and mitigate the risks associated with seasonal price movements, among other things. Nicor Gas also operates a system of natural gas distribution and transmission assets that allow it to take gas delivery from interstate pipelines, move company-owned or customer-owned gas to and from Nicor Gas' storage fields, move gas between and within the major areas of Nicor Gas' service territory, control gas flows and reduce gas pressure so that it flows through local distribution gas mains and pipes.

Test Year

The Company proposed a future test year of the twelve months ending December 31, 2005. The 2005 test year data were based on the Company's 2004 and projected 2005 revenues, expenses, and rate base items. No party contested the use of the proposed 2005 test year.

II. RATE BASE

Accumulated Deferred Income Taxes

Staff proposed an adjustment to increase the Company's Accumulated Deferred Income Taxes (ADIT), to which Nicor agreed. No other party has contested this issue.

Adjustment to Accounts Payable Relating to Gas in Storage

Consistent with its withdrawal of its adjustment regarding Gas in Storage, Staff withdrew its proposed adjustment to Accounts Payable relating to Gas in Storage. No other party has contested this issue.

Materials & Supply Inventory, and Reserve for Injuries & Damages

Staff withdrew its proposed adjustments to Materials & Supply Inventory, and Reserve for Injuries & Damages. No other party has proposed adjustments regarding these issues.

Regulatory Tax Liability

Staff withdrew its adjustment to regulatory Tax Liabilities, agreeing with Nicor that the proposed adjustment would have no net impact on rate base.

Accumulated Depreciation

The methodology for calculating the accumulated depreciation balance is not contested and depends entirely on the conclusions reached on other contested issues regarding utility plant. The Appendix attached to this Order shows the resulting adjustment to the accumulated depreciation that is adopted.

Deferred Taxes

There are several individual issues in this proceeding that relate to ADIT amounts including average rate base, plant balance, the Daily Metering Project, the Mainframe Project, net pension asset, and Section 263A, all of which are addressed elsewhere in this Order. Consistent with its determinations regarding the aforementioned associated adjustments, the appropriate ADIT adjustment is shown in the Appendix to this Order.

Year-End or Average Rate Base Methodology

Nicor

Nicor Gas' proposed net rate base is based on its forecast of all components of its rate base as of December 31, 2005, except for the three rate base items that it calculated based on its forecast of the 13-month average ending on that date (Materials and Supplies, Gas in Storage, and the Budget Payment Plan). Under the rules applicable to rate cases, Nicor is permitted to propose an end-of-year rate base with its forecast test year. Nevertheless, Staff witness Struck proposes that the Commission base the determination of all rate base items (except for the three items calculated using a 13-month average) on the average of the forecasts for December 31, 2004 and December

31, 2005, not on the forecast for December 31, 2005 alone. Nicor contests the adjustment, which it estimates will reduce net rate base by $40,069,000.

According to Nicor, Staff's proposed adjustment effectively denies recovery of substantial prudent and reasonable costs that Nicor already has incurred or will incur this year for plant that is used and useful in order to provide adequate, safe, and reliable tariffed services to customers. Nicor asserts that Staff identifies no rate base item that is imprudent, unreasonable, or unnecessary.

More specifically, the Company argues that Staff's methodology permits recovery of only half of the 2005 capital costs of the capital projects on Schedule F-4. Approximately $16,700,000 of Staff's adjustment is attributable to this item. Nicor contends that no party contested that the capital projects on Schedule F-4 of Part 285 are prudent, reasonable, and used and useful in providing tariffed services, and that the costs of each of these projects are prudent and reasonable.

In addition, Staff's proposed adjustment indirectly denies recovery of another $22,532,000 of net plant, because it is based on an increase in ADIT that is subtracted from net plant in calculating net rate base. Nicor also avers that the ADIT adjustment would disallow half of the impact of Nicor Gas' estimated resolution of the IRS review relating to the election under Section 263A of the Internal Revenue Code. The Company contends that rate basing of the entire amount of the estimated resolution is warranted. (*See infra* at p. 22).

The Company notes that the rates set in this case will go into effect during October, 2005. Nicor states that it has invested roughly $1.24 billion in capital projects since its last general rate case; that its gross plant, net plant, capital expenditures, and net capital additions have increased every year since 2000, and are forecast to do so again in 2005; and that its 2005 capital expenditures now are forecast to be $1,500,000 over the 2005 budget level included in its original forecast.

Nicor contends that Staff's average rate base methodology is arbitrary. Although it notes that 83 Ill. Adm. Code § 285.2005(e) requires the utility electing a future test year to provide thirteen months of rate base balances, it does not mandate that an average balance be imposed. Nicor avers that Staff's purported "better matching" of the rate base to test year operating expenses is vague and fails to take into account when, during the test year, an investment occurs. The Company also contends that Docket 90-0072, cited by Staff, is unavailing because it does not address whether the utility was in a period of increasing investment. Moreover, Nicor argues, the subsequent cases cited by Staff do not present Commission decisions on litigated issues. Accordingly, Nicor contends that there is no longstanding "practice" as suggested by Staff.

<u>Staff</u>

Staff urges the Commission to adopt Mr. Struck's recommendation to convert the Company's proposed year-end rate base to an average rate base for the test year. According to Staff, an average rate base is superior to a year-end rate base at matching the level of rate base investment with the revenues and expenses during the test year.

The adjustment would produce an average rate base for the test year that is $40,069,000 lower than the year-end rate base proposed by the Company.

Staff disagrees that the use of an average rate base would disallow substantial prudent and reasonable costs that Nicor Gas has incurred or will incur during the test year that are used and useful in order to provide adequate, safe, and reliable tariffed services to customers. According to Staff, rate base methodologies are not the same as adjustments to individual rate base components. Rather, Staff explains, an average rate base is an alternative rate base, unrelated to disallowances for particular rate base items. Moreover, Staff asserts, an average rate base is more appropriate in this case than Nicor's proposed year-end rate base because it better matches revenues and expenses throughout the test year with the corresponding level of investment throughout the test year. Staff also notes that Nicor proposed an average rate base with a future test year in its 1995 rate case, Docket 95-0219.

Staff further argues that a year-end rate base can be more forward looking, while an average rate base more accurately matches the return on rate base during the test year with the costs incurred during that year. Thus, Staff claims, an average rate base better reflects the cost of providing service for the test year. Furthermore, a future test year is based on financial projections and therefore is already forward looking. Accordingly, Staff maintains that the average rate base is more appropriate.

Staff notes that the Commission has previously addressed the issue:

> 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, 6-7.) As the Commission noted in Docket 90-0072, the question was a close issue. Nevertheless, Staff emphasizes, Illinois utilities have established a practice of following the foregoing ruling, using an average rate base with a future test year.

Staff agrees with the Company that 83 Ill. Adm. Code Part 285 does not prohibit utilities from proposing a year-end rate base regardless of the type of test year chosen. Staff asserts, however, that the lack of a Rule prohibiting 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 views Part 285 to reflect the Commission's practice of using an average rate base with a future test year. Part 285 requires a company choosing a future test year to also provide information to determine an average rate base, regardless of the rate base the company actually proposes. (*See* 83 Ill. Adm. Code § 285.2005(e).) The Commission's rules do not require this information when a company chooses an historical test year.

Finally, Staff argues that a utility preparing a rate case chooses both when to file its rate case and whether to propose a future or historical test year. In the current case, the Company chose both a 2005 future test year and a filing date of November 4, 2004. Staff argues that the Company's choices do not provide a sufficient reason to use a year-end rate base with the chosen future test year.

Commission Analysis and Conclusion

At issue is whether to accept the Company's proposed year-end rate base, or instead to accept Staff's proposed average rate base and a corresponding downward net rate base adjustment of approximately $40,069,000. Both parties refer to 83 Ill. Adm. Code § 285.2005(e), which states:

> 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.

The plain text of Part 285.2005(e) requires that a utility electing a future test year provide 13 months of rate base data, but does not mandate that the average rate base be used. In other words, it requires that the data be provided to determine whether or not the average rate base is superior to year-end rate base but does not dictate the methodology.

Staff also contends that Docket 90-0072 determined the issue, and that subsequent cases have demonstrated a Commission "practice" that an average rate base be used with a future test year. However, the above-quoted language cited from 90-0072 does not clearly state a general rule. Instead, it addresses the question for that case, finds it to be a close issue, and ultimately decides in favor of the average rate base. Subsequent cases, in which this issue was not litigated, contribute little toward this discussion. On the other hand, Nicor's argument that 90-0072 does not consider whether the utility was in a period of increasing investment is well taken; such a factor should be examined to determine if it renders the year-end rate base the more appropriate measure.

The Commission further notes that the Part 285 Rules were revised in Docket 02-0509, and took effect on August 1, 2003. During that rulemaking, the Commission could have adopted a rule simply stating that a 13-month average rate base always should be used with a future test year. Instead, the less specific language of Part 285.2005(e), cited above, was adopted. All of the foregoing indicates, as a preliminary matter that, while a utility electing a future test year must provide 13 months of rate base data, there is no codified requirement that an average rate base must also be adopted.

The Commission still must resolve the question of whether an average rate base is warranted in the instant case. Nicor avers that investment has been increasing substantially, and that the average rate base would result in a substantial underrecovery.

	Gross Plant	Net Plant
2000	$3,246,784,796	$1,561,745,186
2001	$3,357,208,759	$1,570,371,966
2002	$3,484,358,702	$1,597,616,069
2003	$3,624,330,986	$1,624,841,222
2004	$3,755,100,512	$1,648,026,465
2005	$3,893,853,000	$1,689,085,000

(*See* Nicor Ex. 48.) While Staff contends that these figures do not necessarily demonstrate a period of increasing rate base given that the rate base in the instant case is less than that in Docket 95-0219, the Company points out that the decrease in rate base is attributable to its election under Section 263A of the Internal Revenue Code (26 U.S.C. § 263A) (*see infra*).

The Commission finds insufficient support for Staff's position that rate base is not increasing. The Commission does agree with Staff that an average rate base methodology does not identify particular rate base items that are imprudent, unreasonable, or unnecessary, Nonetheless, given the increase in investment during the test year, the Commission agrees with Nicor that the likely effect of such an adjustment would be an under-recovery of investment in net rate base. Accordingly, Staff's proposal is rejected. The Commission emphasizes that the determining factors in the instant case are the recent trend of increasing net investment in rate base, and the likely under-recovery which would result from adopting the Staff proposed average rate base.

Utility Plant Balance

<u>Nicor</u>

Nicor emphasizes that Staff does not suggest any changes to Nicor's forecasting procedure for capital expenditures. Nevertheless, based on a simple average of Nicor's capital budget versus actual capital expenditure variances, expressed as percentages, from 1998 to 2003, Staff witness Griffin has proposed a 3.3% reduction to budgeted capital expenditures for each of 2004 and 2005. This would result in a downward adjustment to net plant, and thus to net rate base, of $8,742,000.

Nicor argues that Mr. Griffin's proposal is arbitrary and ignores the relevant facts regarding the variances on which his methodology is based. Had Mr. Griffin chosen a five, four, three, or two year average, the Company asserts, his methodology would have produced a smaller proposed disallowance. Nicor also contends that, if Mr. Griffin's methodology were to be adjusted for two mid-year project cancellations in 1998 and 2002, it would support an increase to Nicor's plant balance. According to Nicor, Mr.

Griffin's 1998 data point alone, which was not adjusted for the 1998 cancellation, causes 88% of his proposed adjustment. Nicor also asserts that its 2005 capital expenditures currently are forecast to exceed its budgeted capital expenditures by $1,500,000.

AG witness Effron proposes to use an average of Nicor's net plant additions in the years 2002, 2003, and 2004, and to substitute the actual 2004 year-end total plant balance for the forecast 2004 year-end total plant balance. Those proposals, together, result in a proposed downward adjustment of $14,196,000 to net plant and, thus, to net rate base. According to Nicor, Mr. Effron addressed the impacts of his proposed adjustments on the Depreciation Reserve and depreciation expense but appears not to have addressed the impacts on ADIT.

Nicor contends that Mr. Effron's proposed net capital additions adjustment is arbitrary, and ignores the impacts of non-recurring events, including the project cancellation in 2002. The Company also argues that the claimed tendency of Nicor to overestimate capital additions relies on the same data as Staff's proposed capital expenditures adjustment. Additionally, Nicor notes that the AG's proposed adjustment used a level of net capital additions lower than the actual level for the two most recent years in his three-year average (2002 and 2003). Finally, the Company asserts that Mr. Effron presented no valid grounds for rejecting Nicor's forecast plant balances as of December 31, 2005, based on the actual plant balance as of December 31, 2004. The Company therefore asserts that the AG's adjustment lacks merit.

Staff

Staff witness Griffin proposes reducing the Company's forecast Capital Expenditures for 2004 and 2005 by 3.3%. Mr. Griffin's methodology for determining his adjustment was to randomly select the years 1998-2003 and compare the actual Capital Expenditures with budgeted Capital Expenditures for that randomly selected period. Staff asserts the analysis shows that the Company's actual Capital Expenditures are volatile, with variances during the period analyzed ranging from 17.5% below to 8.0% above the budgeted amount. Staff also notes that preliminary 2004 Capital Expenditure results are 3.4% lower than the Company's 2004 forecast.

For ratemaking purposes, Staff asserts that the Company's forecast Capital Expenditures should be adjusted by the average variance to budget. Given the volatility of the variances, it is appropriate to look at historical information to predict what is likely to occur in the test year. Staff notes that it does not take issue with the procedure used by Nicor Gas for forecasting capital expenditures; the purpose of the adjustment is to account for the average variance based upon past performance.

The AG also proposed adjustments to the forecasts for the years 2004 and 2005. Mr. Effron proposed using the preliminary actual capital additions for 2004 and using the average capital additions for 2002 and 2003 as a substitute for the 2005 forecast additions. Mr. Effron also proposed adjustments for the related effects upon accumulated depreciation and depreciation expense. Staff asserts that Mr. Griffin's method is more appropriate because it calculates the average historical difference between actual capital expenditures and the Company's forecasts.

AG

Nicor's forecast 2005 test year utility plant figure is based on outdated and incorrect forecasts of 2004, which are in turn based on actual 2003 data. The actual 2004 figures for utility plant are now available. Therefore, the Commission should reject Nicor's outdated forecast in favor of Effron's adjustment, based on more recent data.

The gross utility plant included in rate base is the forecast balance as of the last day of the test year. The Company began with the actual balance of plant as of December 31, 2003, and then adjusted that balance for forecast additions to and retirements from plant in calendar years 2004 and 2005. The forecasts of additions to plant in both 2004 and 2005 are greater than the additions in either 2002 or 2003. Furthermore, the actual net additions to utility plant in 2004 were less than initially forecast by the Company. In fact, the actual net additions in 2004 were closer to the actual net additions in 2002 and 2003 than to the Company's forecast. The forecast of plant additions in 2005 deviates even more from the Company's actual experience in recent years than did the forecast of additions for 2004. Therefore, the Company's forecast balance of utility plant as of December 31, 2005, should be modified.

The plant balance as of December 31, 2004, should be adjusted to incorporate the actual balance as of that date rather than the Company's forecast. The forecast of plant additions in 2004 overestimated plant additions compared to recent years; actual additions confirms that the forecast was too high.

The forecast of plant additions in 2005 also should be modified. There was little deviation in the actual plant additions in 2002, 2003, and 2004. The Company's forecast of additions in 2005 represents a significant increase from the actual experience in those years. The AG contends that the Company did not adequately explained this deviation, and suggests that, instead of the Company's forecast, the average rate of the plant additions in the years 2002, 2003, and 2004 should be adopted as the forecast for 2005 additions. The AG advocates that this estimate, less forecast 2005 plant retirements, should be added to the actual utility plant as of December 31, 2004, as a forecast plant balance for December 31, 2005.

Commission Analysis and Conclusion

At issue is whether a pattern of variances between the forecast and actual net plant additions necessitates an adjustment to the test year plant balance forecast. If an adjustment is warranted, several methodology issues also must be resolved. The Commission ultimately finds that a 0.8% reduction is warranted.

The evidence demonstrates a recent history of budgeting overestimates that occurred more often than not. The Commission finds that an adjustment to the test year forecast is reasonable in this circumstance. Staff's adjustment would normalize the Company's forecast based on historical variances, while the AG's adjustment would reconstruct the entire forecast and apply its normalized rate of plant additions in the process. The

Commission accepts Staff's general approach, and notes that normalizing adjustments to volatile components have been adopted in the past. (*See, e.g.,* 03-0008/03-0009 (cons.) (Oct. 22, 2003) at 21-22, 36-37.) Furthermore, it is clear that Staff's adjustment is based on the net variance. The AG's adjustment, however, accounts for the variance only of forecast additions; it is not clear that the AG's adjustment also would account for any offsetting variance in retirements.

Certain issues must be clarified before the adjustment is applied, however. Staff originally advocated its method to adjust the 2004 estimate, and used that estimate to predict the 2005 estimate. Actual 2004 values have become available during the pendency of the case, however, and it is illogical to ignore them. Accordingly, the actual –3.4% variance for 2004 shall be considered.

Staff also describes the data period it considered as "randomly selected." It is unclear how a time series of annual values can be selected at random; by definition, the variable of interest is measured each year for the chosen interval of time. In this case, Staff chose to begin the measurement period in 1998. The Company claims that this choice includes an unrepresentative value for 1998 that significantly biases any adjustment to the 2005 test year. In the Commission's view, the 1998 data does differ substantially from the others in the data set, and with the 1998 beginning point, the data set runs for an atypical length. Considering the lack of a reasonable explanation for any of these aspects, the Commission believes that Staff's proposed period is arbitrary rather than random.

In the absence of a rational reason to adopt a different period, the Commission follows the five year period used for normalizing adjustments in other proceedings including 03-0008/03-0009. To be clear, the period shall include the years 2000 through 2004. The record indicates that the variance between budgeted utility plant additions and actual plant additions in each of those years were -7.6%, 5.4%, -6.4%, 8.0% and, -3.4%, respectively. As a result, the adjustment adopted by the Commission is a 0.8% reduction, rather than the 3.3% reduction originally proposed by Staff.

Mainframe Project

Nicor

Nicor opposes any adjustment to the mainframe computer project as an inappropriate reduction to its revenue requirement. Nicor has included in its rate base $4,700,000 in capital costs for the Mainframe Project. This project is the replacement of the 1992 mainframe computer which Nicor states is prudent, reasonable, and used and useful. The Company contends that one early purchase discount in 2004 should not be isolated and consequently result in a corresponding reduction in their 2005 Gross Utility Plant balance. Nicor argues that businesses frequently go over or under budget on capital expenses. It would be unworkable to review and account for all possible variances, and incongruous to consider this item alone. Finally, it is uncontested that Nicor's 2005 capital expenditures currently are forecast to exceed its budgeted capital expenditures by $1,500,000. Therefore, Staff's proposed adjustment should be rejected.

Staff

Staff witness Griffin proposes the disallowance of $522,000 from the net rate base to account for an early purchase discount for the Mainframe project. Staff contends that the Mainframe project is one of the major projects identified in the Company's filing as projects added to the rate base since the last rate case. Accordingly, it is appropriate to make this adjustment to reflect the discount as a known and measurable change to the cost of the project.

Commission Analysis and Conclusion

The Commission concurs with Staff's proposed adjustment to rate base to reflect this known and measurable change to the cost of the mainframe project. The Commission finds the actual amount expended for the mainframe project to be significant. It is undisputed that there was an early purchase discount Nicor received for the mainframe project. Therefore, the Commission finds that a deduction is appropriate to properly reflect this discount in rate base.

Daily Metering Project

Nicor

Nicor has included in the 2005 rate base the capital costs of its daily metering project. This project entails the daily metering for Transportation customers selecting variable backup. Staff witness Mr. Griffin has proposed the disallowance of $389,000 in associated costs with this project on the basis that Nicor has violated its own budgeting policy. Nicor opposes Staff's proposal and contends that, even if Mr. Griffin were correct in his personal interpretation of Nicor policy, the policy would be inapplicable to "prudent and reasonable costs or a prudent, reasonable, and used and useful project." (Init. Br. 32.) Nicor also asserts that the daily metering project was in fact completed $131,000 under budget with overheads excluded. Nicor claims the removal of overhead expenses is a "long-established" Nicor practice. Further, Nicor points to the fact that Mr. Griffin acknowledged the separation of direct and overhead costs as being a long term practice of the Company that is consistent with their interpretation of their policy. Additionally, Nicor claims this separation policy is consistent with its capital budgeting and with its policy. Finally, according to Nicor it is arbitrary to enforce Mr. Griffin's personal reading of the policy and neglect the Company's current and past interpretive implementation.

Staff

Staff has proposed to reduce of the Company's daily metering project in the amount of $389,000. This is the amount by which the Company went over its authorized expenditure for the project. Staff contends that Nicor makes the unsubstantiated argument that Mr. Griffin's personal interpretation should not be the basis for disallowance of prudent and reasonable costs. Nicor, however, goes no further and fails to establish the daily metering project costs were in fact prudent. Furthermore, Nicor's internal policy is in place to assure that project affiliated costs are prudent:

> [Nicor policy] Article VIII
>
> Actual expenditures for each project that exceed $250,000 shall be reviewed by the department responsible for performing the work or administering the contract. Revisions to authorizations shall be requested when the cost to continue a project differs from the last authorized amount by ± $200,000 or more, a revision to the authorization is required regardless of the percentage.

Staff contends that, just because Nicor is consistent in violating its own policy does not negate the fact that it is a violation. If the Commission were to adopt such logic then recovery of all imprudent and unreasonable costs would be permissible as long as it was done consistently. Therefore, the Commission should adopt Staff's adjustment.

Commission Analysis and Conclusion

At issue here is whether to disallow from rate base the portion of the daily metering project's cost which is in violation of Nicor's policy on such expenditures. Nicor's primary argument, is that in calculating project costs overhead expenses are to be excluded. Staff refers to specific language in the Company's policy which states "actual expenditures," and takes the position that any monies exceeding the policy amount should be disallowed in the rate base. The Commission agrees with Staff and finds the reduction of the daily metering project in the amount of $389,000 to be appropriate.

Nicor claims that the prudence and reasonableness of the daily metering project renders the policy a secondary consideration. The Commission disagrees. Nicor's policy is in place internally to ensure the prudence and reasonableness of expenditures. There is no exception for overages incurred in the completion of a project. Nicor also contends it is in fact under budget with the removal of overhead expenses, as is their long standing practice. The policy focuses on "actual" expenditures, however, which includes overhead costs. Additionally, Nicor concedes that it has a long standing practice of disregarding this policy and did so specifically with respect to this project. The Commission, therefore, concurs with Staff that Nicor's consistent violation of its own policy does not serve to absolve them of the violation. Accordingly, the daily metering project shall be reduced in the amount of $389,000 from the rate base.

Gas in Storage

Nicor Gas

Computation of Gas in Storage

Nicor calculated the Gas in Storage addition to rate base at $106,867,000, using the price of natural gas as of February 7, 2005, the date on which Staff proposed an update to Nicor's rate of return.

Nicor's calculation utilizes a 13-month average, resulting in the figure of $106,867,000. Nicor argues that the 13-month average is more accurate and appropriate than a 12-month average. Nicor argues that application of the 13-month average is consistent with the last general rate case involving Nicor, as well as other proceedings before the Commission. (*See* 02-0837, 01-0470, 01-0469, 00-0575, and 00-0228.)

Nicor asserts that CUB/CCSAO's three proposed adjustments would reduce the Gas in Storage addition by $164,776,891, approximately 167% of Nicor Gas' original proposal of $98,724.000 (later updated to $106,867,000). Nicor argues that the 13-month methodology it employs is superior to the 12-month average proposed by CUB/CCSAO because it more accurately represents the average balance over an entire year and better approximates the daily balances within that year. According to Nicor, a 12-month average only approximates the average of each daily balance from January 31 to December 31 and, by doing so, ignores the opening balance of the year. Nicor argues that the 13-month average does not give inappropriate weight to one month, and that no month is double-counted. Nicor states that it made its computation using a calendar year, because it was calculating a forecast 2005 test year, and that it would not be reasonable to begin the calculation in a non-calendar year.

Nicor further argues that CUB/CCSAO is selectively applying the 12-month methodology to Gas in Storage, where the result is a reduction to the rate base, but not to Materials and Supplies and Budget and Payment Plan Balances, where the result would increase rate base by approximately $4,336,000.

Nicor further argues that, even if a 12-month average were used in this case, CUB/CCSAO's calculations based on a 12-month average are incorrect. Nicor states that the figure should instead be calculated under that methodology as of March 31, 2005 at $109,964.000 for the Gas in Storage addition and $20,911,000 for the adjustment.

LIFO

Nicor opposes CUB/CCSAO's proposed adjustment of $95,308,248, which is based on Nicor's liquidation of low-cost LIFO layers of gas. Nicor contends that CUB/CCSAO did not present sufficient evidence to support its adjustment and that, under CUB/CCSAO's own theory, the correct adjustment would be the lower amount of $12,988,874.

Nicor points out that the reasonableness of liquidating certain low-cost Gas in Storage inventory while the Gas Cost Performance Program ("GCPP") was in effect is being separately litigated in the matter of *ICC v. N. Ill. Gas Co*., Docket 02-0067. Nicor reasons that relief is available to the ratepayers in the form of customer refunds, if deemed appropriate, in Docket 02-0067. Nicor argues that any reduction in the instant case, which is later determined to have been inappropriate, cannot be remedied in Docket 02-0067 or any other proceeding.

Nicor further argues that its restated financial statements, independently audited by Deloitte and Touche, LLP, record all appropriate accounting adjustments to Nicor's LIFO inventory as a result of the GCPP for the years it was in effect. Nicor states that the portion of the LIFO liquidation occurring during the GCPP, which continued to be reported on Nicor's restated financial statements, was merely the result of normal, reasonable, and customary storage field operations. Nicor further states that CUB/CCSAO has not identified any error in these restated financial statements. Nicor argues that its computation is consistent with Accounting Principles Board Opinion No. 28 and Rider 6.

Valuation of Gas in Storage

Nicor proposes a rate base addition of $106,867,000 with an additional $18,453,000, resulting in a total of $125,320,000. As evidence that its gas distribution to ratepayers is on a last-in, first-out basis, Nicor notes that recently purchased LIFO layers of gas are used before previously purchased layers. Nicor states that its large Gas in Storage balance was purchased at then-current market rates in the preceding summer and fall for injection into storage. Nicor states that it carries the cost of that gas during the winter months until the gas is withdrawn.

Nicor does not dispute that the gas purchased during the preceding summer and fall was purchased at a lower rate than the current market rate during the winter months. Nicor argues, however, that CUB/CCSAO's computation fails to consider Nicor's cost to store gas purchased in the preceding summer and fall until its use in the winter months. Nicor therefore objects to CUB/CCSAO's proposed adjustment of $57,999,286.

Reduction in Transportation Customer Values

Nicor proposes an increase of $18,453,000 to rate base to reflect the increased amount of Gas in Storage. Nicor will be responsible for filling under its proposal to decrease the capacity of storage allocated to Transportation customers from 26 to 23 times the Maximum Daily Contract Quantity ("MDCQ"), based on the impact of proposed revisions in transportation service tariffs.

<u>Staff</u>

Staff has withdrawn its proposed adjustment to the Gas in Storage addition computed by Nicor, and now supports Nicor's figures for both the update and the adjustment.

Staff proposes that the following language be included in the final order regarding future leased storage management contracts, which Nicor found acceptable:

> Prior to its entering into any agreement with a third party for the management of leased storage which would reduce the volume of gas in inventory held by Nicor Gas, the Company must provide Staff with a copy of the analysis used by the Company establishing the benefits of entering into such an agreement.

<u>CUB/CCSAO</u>

Computation of Gas in Storage

CUB/CCSAO contend that Nicor's Gas in Storage addition should be reduced by $11,469,000. CUB/CCSAO maintain that a 12-month computation method should be utilized instead of Nicor's proposed 13-month method. CUB/CCSAO contend that the 13-month method counts December twice, thus distorting the balance of the gas in storage calculation. CUB/CCSAO argue that, using the 13-month method, the result would be different depending on which month was used as the starting month. CUB/CCSAO contend that it is not reasonable to use a procedure that provides different results depending on which month of the year is used as the starting point in the calculation.

CUB/CCSAO contend that the mathematically correct way to compute the gas in storage carrying charge is to use the 12-month method, which would compute an average balance for each month by averaging the balances that existed at the beginning and end of each month, then averaging these 12 monthly balances. CUB/CCSAO contend that the opening balance of the calendar year is appropriately considered using this 12-month method, and that the balances for the period January 1 through 30 are not ignored.

CUB/CCSAO dispute that they are being unfair in proposing a 12-month average in this instance but not using it for Materials and Supplies and Budget and Payment Plan Balances. CUB/CCSAO suggest that if the Commission determines consistency to be important, the 12-month average could be applied to these other areas, as well.

LIFO

CUB/CCSAO contend that there should be an adjustment of $95,308,248 to the Gas in Storage computation. CUB/CCSAO argue that Nicor improperly liquidated 25,565,000 Dth from its low-cost LIFO layers under the GCPP. While the average cost for the liquidated layers was $2.00 per Dth, Nicor replaced the liquidated amounts with gas priced at $5.81 per Dth. CUB/CCSAO argue that the replacement of the low-cost storage inventory in this manner increased Nicor's beginning of test period storage inventory balance by $95,300,000, which served as the starting balance for computation of the average test period storage inventory and its claim for storage inventory carrying charges. CUB/CCSAO argue that Nicor should therefore be denied carrying charges on the difference between the $5.81 and $2.00 per Dth gas. CUB/CCSAO argue that Nicor's requested rate base of $61,700,000 should be reduced by $25,900,000.

CUB/CCSAO also argue that the Commission should use this case to reduce the carrying charges amount. According to CUB/CCSAO, because Docket No. 02-0067 is pending, Nicor has not met its burden in the instant case of showing that the requested carrying charges on the higher cost replacement gas are reasonable. They argue that Nicor's request is, therefore, premature. While CUB/CCSAO agree that this case is not the proper forum to evaluate Nicor's decisions under the GCPP, they disagree that the relief available under Docket No. 02-0067 is adequate. CUB/CCSAO contend that if this issue is not decided here, customers will pay higher carrying charges indefinitely, and will thus have been negatively affected twice: once by the improper liquidation under the GCPP and again with the increased carrying charges due to the purchase of the higher priced gas. CUB/CCSAO contend that awarding Nicor higher carrying charges for the higher priced gas would reward Nicor for deceptive and misleading practices in covertly liquidating the low-cost gas. CUB/CCSAO propose that, if legally permissible, the Commission can revisit the issue of whether to award Nicor additional carrying charges after a ruling has been made in Docket 02-0067.

CUB/CCSAO contend that the Commission, not Nicor, must decide whether Nicor's restated financial statements regarding Nicor's LIFO inventory are correct. CUB/CCSAO contend that Nicor cannot then use the "correctness" of their financial statements as an argument against the reduction in carrying costs. CUB/CCSAO points to an occasion where the independent auditor and Nicor found financial statements previously filed by Nicor to be incorrect.

Further, CUB/CCSAO contend the amount of reduction should be $95,308,248, not the $12,988,874 Nicor computed by allegedly using the same formula. CUB/CCSAO attributes this discrepancy to Nicor's assumption in its computation that ratepayers received savings under the GCPP. CUB/CCSAO points out that no decision has been reached on this issue in Docket 02-0067, and that there is no evidence of these savings. CUB/CCSAO also states that the computation should be performed using the 12-month rather than the 13-month formula.

Valuation of Gas in Storage

CUB/CCSAO propose that an adjustment of $57,999,286 be made to Nicor's computation of Gas in Storage to account for Nicor's significant cash flow advantage. CUB/CCSAO argue that Nicor will receive revenues from the withdrawal and use of gas from the low-cost LIFO layers that will exceed its storage inventory investment. CUB/CCSAO state that gas that was purchased by Nicor at rates as low as $0.30 per Dth will be sold to the ratepayer at $5.90 per Dth, resulting in a profit to Nicor.

CUB/CCSAO have presented evidence in support of their argument that an adjustment should be made in the amount of $57,999,286 to offset profit made by Nicor on gas withdrawn and charged to ratepayers at current annual LIFO prices. CUB/CCSAO argue that the carrying charges proposed by Nicor are unjust and unreasonable because their calculation ignores a significant benefit received by Nicor.

CUB/CCSAO state that when gas is withdrawn from storage during January through April, ratepayers are charged a price equal to the estimated annual cost of all gas purchased by Nicor during that year. This cost is known as the current year's annual LIFO price.

CUB/CCSAO argue that Nicor purchased gas in the earlier LIFO layers at rates as low as $0.30 per Dth, but that gas is being billed out to consumers at the current annual LIFO price of $5.90 per Dth. CUB/CCSAO argue that the difference between the cost at which the gas was purchased and the price paid by consumers at the time of withdrawal gives Nicor undeserved profit at the expense of the ratepayers. CUB/CCSAO contend that the revenues Nicor receives will exceed its storage inventory investment. Specifically, CUB/CCSAO argue that Nicor will make a profit of $5.60 per Dth. CUB/CCSAO contend that ratepayers are actually advancing money to Nicor, which Nicor then uses to purchase replacement gas in May through October. CUB/CCSAO argue that Nicor's claim for storage inventory carrying charges should be based on what the gas cost Nicor before it was placed into storage, and should not be based on the expected replacement cost of the gas being removed from storage.

Reduction in Transportation Customer Values

CUB/CCSAO does not oppose Nicor's proposal to decrease the volume of Gas in Storage allocated to Transportation customers.

COMMISSION ANALYSIS AND CONCLUSION

Computation of Gas in Storage

The Commission finds that Nicor Gas properly calculated the Gas in Storage addition to the rate base using a 13-month average, resulting in a figure of $106,867,000. This method of computation is consistent with the Commission's last rate order relating to Nicor and other proceedings, which approved use of a 13-month average. Staff does not oppose the methodology used or the resulting figure. The Commission is persuaded by the argument that a 13-month average is more representative of the average balance for a full year, whereas a 12-month average from January 31 to December 31 does not utilize data from the opening balance of the year. Also, the 12-month average is inappropriate in its exclusion of the opening balance of the year. The Commission does not find that the 13-month average gives inappropriate weight to one month, and does not find that any month is double-counted. Further, if a 12-month average were applied to the Gas in Storage issue, it should also be applied to other issues, to maintain consistency. CUB/CCSAO argue for a 12-month average for Gas in Storage but accepts a 13-month average in other areas. For these reasons, the 13-month average methodology is accepted, resulting in a figure of $106,867,000.

LIFO

The Commission finds that Nicor has presented sufficient evidence to support its Gas in Storage addition to the rate base. The issue of whether it was reasonable for Nicor to liquidate certain low-cost Gas in Storage inventory while the GCPP was in effect is being separately litigated in Docket 02-0067. Because that issue will be given full consideration in Docket 02-0067, and because appropriate remedies are available in that case, that issue will not also be addressed in the present case. Further, if Nicor were penalized in the instant case for a result that remains uncertain at this point in Docket 02-0067, Nicor would have to wait until its next rate case to remedy the situation. It is more just to impose appropriate refunds to ratepayers in Docket 02-0067 should that case be decided against Nicor after all the evidence has been heard and considered. Requests for adjustments to Nicor's figures based on Nicor's alleged actions while under the GCPP are denied. As proposed by Staff, the Commission finds that prior to Nicor entering into any agreement with a third party for the management of leased storage which would reduce the volume of gas in inventory held by Nicor Gas, the Company must provide Staff with a copy of the analysis used by the Company establishing the benefits of entering into such an agreement.

Valuation of Gas in Storage

The Commission rejects CUB/CCSAO's proposed adjustment of $57,999,286 to Nicor's computation of Gas in Storage. While the parties do not dispute that Nicor purchased gas in the first-in LIFO layers at lower prices, they do dispute the cost of carrying charges to Nicor. Nicor claims that its last-in first-out method and charging customers for gas at current annual LIFO prices is fair given the carrying costs Nicor has to endure because of the gas storage it provides. The Commission does not find that there is a significant cash flow advantage accruing to Nicor by selling gas to ratepayers at the current year's LIFO prices, given the storage charges borne by Nicor.

Reduction in Transportation Customer Values

Nicor has proposed to decrease the capacity of storage allocated to Transportation customers from 26 to 23 times the Maximum Daily Contract Quantity ("MDCQ"). This would result in an $18,453,000 increase to net rate base, reflecting the increased volume of gas in storage Nicor would be responsible for filling. Several parties object to Nicor's proposal. The merits of Nicor's proposed reduction is discussed *infra* in Storage Capacity Allocated to Transportation customers. The Appendix to this Order reflects the Commission's decision *infra* and the resulting impact on Nicor's rate base.

Pension Asset

<u>Nicor</u>

Nicor Gas has forecast a prepaid pension balance of $186,882,000, from which $75,156,000 (corrected figure) in associated ADIT has been deducted, resulting in a net pension asset of $111,726,000 being included in net rate base. Nicor Gas contends that it has appropriately included the net pension asset in net rate base. According to Nicor Gas, the net pension asset reflects prudent and reasonable investments made by the Company in a pension trust in compliance with its obligations under its pension plan and human resources policy.

The Company concedes that while the pension plan currently is, and in 2005 is projected to be, "overfunded", the Company cannot withdraw, and does not have the use of, any "overfunded" amounts. According to the Company, while pension expense was a component of approved operating expenses in the years leading up to the Company's last general rate case, customers did not pay a separate charge or a segregated portion of any charge that directly funded or was tied to the pension asset. Customers did not fund the pension asset any more than they funded any particular item of gas plant. The payments made into the pension trust were made by Nicor Gas, not customers.

Despite the fact that the Commission, in its Order in the Company's last general rate case, Docket No. 95-0219, rejected the inclusion of the then-forecast net pension asset in Nicor Gas' proposed net rate base, the Company maintains that approval of recovery in this case is warranted, notwithstanding the prior Order's disallowance.

Despite the fact that the Commission, in its Order in the Company's last general rate case, Docket No. 95-0219, rejected the inclusion of the then-forecast net pension asset in Nicor Gas' proposed net rate base, the Company maintains that approval of recovery in this case is warranted.

Nicor characterizes Staff witness Pugh's position as "a novel form of retroactive ratemaking combined with single issue ratemaking." According to Nicor, Staff erroneously contends that too much of one type of OO&M expense (pension expense) was approved prior to the last Nicor Gas general rate case, with "too much" being improperly determined by Ms. Pugh in hindsight, based on the subsequent performance of the pension trust. Nicor maintains that, even if a retrospective analysis were appropriate, Ms. Pugh's theory would be illogical and unfair unless she could show that there were not offsetting shortfalls in Nicor's recovery of other operating expenses. With under-recovery of other operating expenses, Ms. Pugh could not properly focus on alleged over-recovery of one expense category and conclude that such "excess" funded the pension asset. Nicor emphasizes in its last general rate case (Docket 95-0219) the Commission found that Nicor experienced a revenue deficiency of $33,732,000. That fact, Nicor insists, cannot be squared with the notion that ratepayers before that case were paying "excess" amounts that funded the pension trust.

In sum, Nicor objects to Mr. Effron's and Staff Witness Pugh's elimination of the prepaid pension asset from rate base. Instead, the Company argues that it should be allowed to include the net pension asset in its rate base.

Finally, Nicor Gas points out that customers have had a reduction in rates of approximately $62.2 million since the 1995 Rate Case. Moreover, Nicor claims, the pension asset has grown by around $67.9 million since the last rate case. As a result, Nicor argues that, in the alternative, it should be allowed to include the net amount of $67,900,000 or $62,200,000 in the rate base. At a minimum, the Company argues that the pension credit, which has no basis in any event, should not be deducted from operating expenses in computing the revenue requirement. Nicor argues there would be no valid basis for the deduction, not least because it is an accounting accrual (rather than actual funds), and it does not offset other operating expenses or provide a means to pay them. In Nicor's view, this deduction would be even more baseless and unfair if any or all the net pension asset is disallowed.

Staff

Staff witness Pugh proposes 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 $184,192,000 pension asset less $78,782,000 of related ADIT.

Staff reasons that since the pension asset was created by ratepayer-supplied funds rather than shareholder-supplied funds, shareholders should not earn a return on the prepaid pension asset. Moreover, Staff points out that witness Pugh's proposed adjustment is consistent with the Commission's finding in Nicor Gas' last rate order. Specifically, Staff points to the Commission's determination in Nicor's last rate case that "the proposal to eliminate the net Pension Asset from rate base is consistent with past Commission orders which found that the overfunded pension asset was created from ratepayer supplied funds." (Docket No. 95-0219, Order, April 3, 1996).

Staff disputes Nicor's contention that Ms. Pugh's position constitutes single issue ratemaking or retroactive ratemaking. According to Staff, Ms. Pugh's approach is not retroactive ratemaking because it is not an attempt to correct a past error or omission. Rather, the adjustment disallows, on a prospective basis, an asset that Nicor proposed to include in test-year rate base for the first time. Similarly, Staff's approach is not single-issue ratemaking because Staff evaluated all rate base components, including the pension asset, in the aggregate on the same basis.

Staff also points out that the Company has proposed to remove either the OPEB deduction from rate base or the pension credit from operating expense. Staff cannot support these proposals since Nicor Gas continues to control the ratepayer-supplied OPEB funds, and the pension credit is an item that Nicor will realize in the test year. Moreover, Staff correctly points out Nicor's acknowledgment that, due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. Thus, according to Staff, the record is clear that the situation has not changed since the Commission's last rate order. For these reasons, Staff urges the Commission to approve its adjustment to reduce rate base by a net amount of $105,410,000.

AG

According to the AG, Mr. Effron's adjustments to Pension Assets are consistent with the Commission's findings in Nicor's last rate case. Mr. Effron has eliminated the prepaid pension asset from rate base, but has treated the accrued liability for postretirement benefits other than pensions as rate base deductions.

In particular, to calculate the Company's pension asset, Mr. Effron treated Retirement Benefits-Net as two components. One is prepaid pensions of $186,882,000. The second is the accrued liability for future postretirement benefits other than pensions, mainly health care costs. The accrued liability as of 2005 is estimated to be $97,855,000. Consistent with the Commission's findings in No. 95-0219, Mr. Effron eliminated the prepaid pension asset from rate base, but treated the accrued liability for postretirement benefits other than pensions as rate base deductions.

He has also eliminated the accumulated deferred income taxes related to the prepaid pensions from the balance of ADIT deducted from plant in the calculation of rate base. The net effect of this adjustment is to reduce Retirement Benefits-Net by $186,882,000 and related ADIT by $75,156,000 for a net reduction to the Company's rate base of $111,726,000.

Commission Analysis and Conclusion

Nicor Gas contends that it has appropriately included a net pension asset of $111,726,000 in net rate base. Staff and the Attorney General, on the other hand, seek to eliminate the prepaid pension asset from rate base. Specifically, Staff witness Pugh proposes an adjustment to reduce rate base by a net amount of $105,410,000, while AG witness Effron's proposed adjustment would disallow $111,726,000. As the Commission understands it, the only difference between Staff's and the AG's respective adjustments is that Staff's is based on an average test year rate base while the AG's is based on a year-end rate base. The Commission concludes that Nicor has failed to justify inclusion of the pension asset into its proposed rate base.

In the Company's last general rate case, Docket 95-0219, the Commission rejected the inclusion of the then-forecast net pension asset in Nicor Gas' proposed net rate base. Specifically, the Commission found, in relevant part:

> [T]he Commission finds that the proposal to eliminate the net Pension Asset from rate base is consistent with past Commission orders which found that the overfunded pension asset was created from ratepayer supplied funds . . .

(95-0219, at 9.)

While acknowledging the Commission's prior Order, Nicor nevertheless maintains that "approval of recovery in this case is warranted, notwithstanding the prior Order's disallowance." However, Nicor has not presented any additional evidence since the 1996 Order to show why the Commission should arrive at a different conclusion now. It remains true that the pension asset was created by ratepayer-supplied funds, not by shareholder-supplied funds.

The Commission disagrees with Nicor's characterization of Staff witness Pugh's proposed adjustment as "a novel form of retroactive ratemaking combined with single issue ratemaking." (Nicor Init. Br. at 39, *citing* Nicor Ex. 26A.0, 55:1238 – 56:1262; *see also id.* at 54:1219 – 1223, 57:1268 – 1279; O'Connor Sur., Nicor Gas Ex. 34.0, 19:436 – 20:462.) The decision to disallow the net pension asset from the net rate base does not constitute retroactive ratemaking or single-issue ratemaking. As the Commission previously held:

> Staff's approach is not retroactive ratemaking because it is not an attempt to correct for a past error or omission, rather the adjustment disallows, on a prospective basis, an asset that NI-Gas proposed to include in test-year rate base for the first time. Similarly, Staff's approach is not single issue ratemaking because Staff evaluated all rate base components, including the pension asset, in the aggregate on the same basis.

(*Id*., at 9-10.) Therefore, the Commission finds no reason to change the treatment of the pension asset. The Company acknowledged that, due to the overfunded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. (*See* Nicor Gas Exhibit 26A.0, p. 56, II. 1266-1267.) The pension credit is an item that Nicor will realize in the test year. The Commission agrees with Staff that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded.

Accordingly, consistent with the Commission's findings in Docket 95-0219, Nicor's prepaid pension asset should be eliminated from rate base. The adjustment should reflect the decision, above, regarding end of year rate base, and is quantified in the Appendix to this Order.

Section 263A

Nicor

In 2003 (in its 2002 federal tax return), Nicor Gas elected to change its overhead capitalization method under Section 263A of the Internal Revenue Code. The election is a timing item, i.e., it defers taxes. According to Nicor, the net impact of the election as of December 31, 2004, was an increase in ADIT of $133,032,557. Nicor Gas' revised proposed net rate base includes a (corrected) reduction of ADIT of $66,563,000, based on its estimated resolution of the Internal Revenue Service ("IRS") review of the election under Section 263A.

The ADIT figure reflects what the Company believes is a reasonable estimate for ratemaking purposes of the outcome of the current review by the IRS of Nicor Gas' accounting methodology change regarding its overhead capitalization method, pursuant to Section 263A of the federal Internal Revenue Code, elected as part of its federal income tax return for the 2002 tax year. Nicor emphasizes that many other utilities across the country made similar elections under Section 263A and that the IRS is looking at this issue industry-wide. Nicor Gas believes, therefore, that its tax filing position was and is appropriate and consistent with federal tax law and regulations.

The Company recognizes, however, that a final IRS review will involve interpretation of tax laws, as well as computational issues. In order to take into account that it may not prevail at the IRS, Nicor Gas has adjusted its forecast test year federal and state deferred taxes by $84.9 million, which represents approximately half of the filed tax position. Nicor Gas thus maintains that its forecast ADIT reflects a reasonable estimate of the most likely outcome, based on available data and given the uncertainties surrounding the subject.

Nicor adds the policy argument that tax deferrals from timing items (such as Nicor Gas' Section 263A election) can reduce customers' rates via a reduction in the Company's financing costs. Nicor reasons that since ratepayers derive benefit from the position Nicor Gas took in its 2002 tax return, the Commission should approve Nicor Gas' approach, which balances the risks between the utility and ratepayers. Nicor is concerned that doing otherwise may result in a chilling effect on utilities trying to optimize tax positions, and that would be detrimental for ratepayers by ultimately leading to higher rates. To illustrate, Nicor argues it is an uncontested fact that Nicor Gas' revised proposed net rate base in the instant Docket would be $66,469,557 higher were it not for the election (i.e., the $133,032,557 impact of the election as of December 31, 2004, less the $66,563,000 estimated resolution, referenced above). Therefore, Nicor concludes, it would not only be unjust and unreasonable, but also bad policy, for the Commission to reduce rate base by the entire impact of the Section 263A election before the resolution of that election.

Nicor contends that AG witness Effron's proposed adjustment would inappropriately disallow $66,563,000 from rate base, which in turn would inappropriately reduce the revenue requirement by $8,615,000. Nicor asserts that Mr. Effron's criticism is both wrong and inexplicable. According to Nicor, Mr. Effron fails to address information and documentation supplied by Nicor Gas in discovery that explains the basis of the estimate. Nicor further claims that Mr. Effron takes full advantage of an ADIT figure that reflects the election in making his net rate base proposal, but regards rate base inclusion of the estimated resolution of the election as "speculative."

Nicor also takes issue with Staff's proposed average rate base in relation to the Section 263A election issue. In its rebuttal testimony, Nicor Gas accepted Staff's computation of the impact of the Section 263A election on ADIT. Nicor and Staff agree on the treatment of Section 263A and only differ on the use of an average rate base as discussed above. Staff accepts the inclusion of the estimated resolution, but maintains that Staff's proposed "average rate base" adjustment would inappropriately and unfairly eliminate 50% of its impact.

AG

The AG argues that Nicor does not adequately support its assumption that the IRS will disallow a portion of a tax election that Nicor made in 2002, pursuant to Section 263A of the Internal Revenue Code. As a result, the AG asserts that it is improper for Nicor to request that the Commission grant it in rate base for the 2005 test year, based on that assumption. AG witness Effron opposes the reduction of ADIT proposed by Nicor Gas and Staff and has suggested that if the IRS review of Nicor Gas' Section 263A election results in the current payment of income taxes that had been deferred, then Nicor Gas could be allowed to accrue the return on the resulting reduction to ADIT for future recovery during its next general rate case. AG witness Effron, therefore, removed Nicor's estimated reduction to Accumulated Deferred Income Taxes ("ADIT") entirely because Nicor's adjustment is entirely speculative. To avoid making ratepayers compensate the Company for a disallowance that likely will not be imposed, the AG urges the Commission should reject Nicor's 263A adjustment to ADIT. The mere possibility that the Company may have to pay some ADIT at some uncertain time in the future is not adequate reason to adopt the Company's adjustment to rate base.

The AG also contends that "Nicor's own analysis argues against its Section 263A adjustment." (AG Reply Br. at 11-13.) The AG also characterizes Nicor's refutations of witness Effron's adjustments as "circular and incorrect." (*Id*. at 13-14.)

The AG also takes issue with Staff's position on this issue, stating that Staff incorrectly relies on the Company's meritless calculations in recommending the approval of Nicor's proposed ADIT adjustment. According to the AG, Staff's reliance on AG Cross Ex. 13 to endorse Nicor's adjustment to ADIT is misplaced. The AG believes it has demonstrated that the Company's adjustment to ADIT is unreasonable for the purpose of a future test year. The AG points to the fact that Staff has failed to cite anything in AG Cross Ex. 13

to support the notion that there is a reasonable expectation that the Company will have to repay any of the deferred taxes related to its Section 263A adjustment at any time in the foreseeable future.

The AG contends that Staff's proposed adjustment would significantly increase rate base, for purposes of ratemaking, without requiring Nicor to meet its burden of proof. Considering the speculative nature of both the pending IRS ruling and the timing of its ruling, the Commission should reject the Company's reduction of ADIT related to the Section 263A tax deductions.

Staff

Staff witness Ebrey proposed an adjustment to increase the Company's ADIT to reflect the required proration and the revised Internal Revenue Code Section 263A ("Section 263A") adjustment proposed by the Company. (Staff Ex. 2.0, p. 9, ll. 168-170 and Staff Ex. 11.0 Revised, p. 2, ll. 21-27.)

Staff disagrees with AG witness Effron's proposed adjustment to ADIT. Staff characterizes the Section 263A election as being "entirely speculative." According to Staff, the evidence in the record, including AG Cross Exhibit 13, indicates the Company's adjustment is reasonable for purposes of a future test year.

Staff points out that Company witness O'Connor agreed with its position that the prorated balance of deferred tax on property should be $18,214,000. The Commission should, therefore, approve the ADIT proposed by the Company of $345,956,000 ($327,742,000) since it is a reasonable estimate of the future test year ADIT balance.

Commission Analysis and Conclusion

At issue is a decision Nicor made in its 2002 federal tax return filing, to change its overhead capitalization method under Section 263A of the Internal Revenue Code. The election is a timing item for taxation purposes. In short, it defers taxes. According to Nicor, the net impact of the election as of December 31, 2004, was an increase in ADIT of $133,032,557. Nicor Gas' revised proposed net rate base includes a (corrected) reduction of ADIT of $66,563,000 based on its estimated resolution of the IRS review of the election under Section 263A. The Commission accepts the Company's position on its 263A election *in toto*.

The Commission finds it somewhat disingenuous to characterize the Company position on this issue as meritless and completely speculative in nature as the AG does. As an initial mater, despite the fact it differs on the use of "an average rate base," Staff agrees with Nicor Gas on the treatment of Section 263A and finds that "the Company's adjustment is reasonable for purposes of a future test year." (Staff Init. Br. at 21). Second, Nicor Gas' forecast financial statements were the subject of an independent examination by C.P.A., Deloitte & Touche LLP, in accordance with the requirements of 83 Ill. Admin. Code § 285.7010.

The Commission also finds unpersuasive the AG's argument that it established through cross-examination that Nicor Gas' forecast financial statements do not reflect the estimated resolution. As Nicor points out, the cross-examination only sought to establish that the estimated resolution is not reflected in line 5, net deferred income taxes, of Schedule G-17, the Statement of Cash Flows. The cross-examination did not address whether the estimated resolution, which involves an estimated payment, is reflected in line 8, net changes in working capital, of Schedule G-17. (O'Connor, Tr. 136-144). The Commission finds that the Company's estimated resolution appears in the forecast financial statements, Schedules G-15 through G-18.

The AG further contends that "Nicor's own analysis argues against its Section 263A adjustment." (AG Reply Br. at 11-13.) The AG also characterizes Nicor's refutations of witness Effron's adjustments as "circular and incorrect." (*Id*. at 13-14). In support of its arguments, the AG points to a series of data responses propounded in discovery. The Commission finds, however, that nowhere in these documents did the Company indicate that the estimated resolution before the IRS was a certainty. In fact, the Company has been consistent in its assertions that there is "a strong likelihood" that the method change will be approved by the IRS. The Company stopped well short of saying it will prevail with certainty. The Commission does not find that any gamesmanship occurred in the discovery process with regards to this issue.

While it is true that the IRS has not yet asserted its position on the claimed tax deductions related to the Company's 263A accounting method change, the AG also fails to take into account that this issue is not mutually and exclusively a Nicor Gas issue. The section 263A taxation issues are an industry-wide concern within the utility industry and the IRS's review is national in scope.

The Commission also finds merit in Nicor's policy argument on the Section 263A election. There would have been negative repercussions had the Company not taken the 263A election in its 2002 federal tax return. The net impact of the election as of December 31, 2004, was an increase in ADIT of $133,032,557. It is undisputed that there is a partial offset of the ADIT reduction. In other words, Nicor Gas' net rate base as of December 31, 2004, would be $133,032,557 higher than it actually was had the tax election not been made in 2003. Moreover, Nicor Gas' net rate base as of December 31, 2005, would be $66,469,557 higher than what it is currently proposing.

In sum, the Commission finds the Company's 263A election reasonable for purposes of ratemaking in this case. Staff's proposed corrections to the calculation are accepted. However, its proposed adjustment that is based upon its proposal to use an average test year rate base was disposed of *supra*. As such, the result of Nicor's election under Section 263A is adopted and the AG's proposed adjustment to rate base is rejected.

Budget Payment Plan

Nicor

Budget Payment Plan balances are cumulative amounts customers who subscribe to the Company's Budget Payment Plan have paid in excess of bills for services rendered (credit balances) or cumulative amounts that customers have paid that are less than the bills for services rendered (debit balances). Nicor included in its proposed revenue requirement a Budget Payment Plan credit balance of $60,965,000. This amount would be deducted from rate base. The Company's proposed balance is based on its forecast 13-month average through December 31, 2005.

Nicor opposes the proposal by the AG, supported by Staff, to increase the Budget Plan credit balance to $83,427,000. According to the Company, the proposed increase to the credit balance is without merit, arbitrary and unwarranted. Nicor states that the AG's proposal has no valid basis, and that witnesses for the AG and Staff offer no more than an opinion for supporting the substitution of actual data as it becomes available, instead of the use of projections.

In summary, Nicor takes exception to use of actual data in this instance, when it is not updating its test year forecasts generally, thereby making the AG's proposal selective and improper. Likewise, Nicor opposes the AG's proposed adjustment to the interest expenses, which would result from the AG's proposed adjusted Budget Payment Plan balance.

AG

The AG proposes increasing Nicor's Budget Payment Plan credit balance to $83,427,000 based upon a 12-month average using actual balances for the last days of April 2004 to March 2005. The AG argues that substitution of actual data for Company forecasts is not a selective update, but rather a correction to Nicor's flawed forecasting.

According to the AG, the actual balances in 2004 appear more typical of the Company's experience than Nicor's outdated forecasts. For instance, the AG highlights the fact that the Company's budget forecast for Budget Payment Plan balances was in error by approximately $40 million for May 2004, a forecasting error which would carry forward, if projections continued to be used rather than averaged actual balances.

Therefore, the AG argues that averaged actual balances are the most objective and most unbiased method for projecting Budget Payment Plan balances for purposes of determining rate base. In addition, the AG's proposed adjustment of the Budget Payment Plan balances would result in an adjustment to the computation of the Budget Payment Plan Interest Expense, increasing the Nicor revenue requirement by $1,446,000.

Staff

Staff initially proposed an adjustment to Nicor's forecast Budget Plan Payment balances, utilizing a 13-month average using actual balances for December 2003 through December 2004. In an effort to narrow the issues in this proceeding, Staff subsequently withdrew its proposed adjustment. However, while doing so, Staff did so "while still maintaining that using actual balances as they are available for projections is superior to the Company's use of 21 months of projected balances." (Staff Init. Br. at 24.) Staff, therefore, while not proposing its own adjustment to the Company's Budget Payment Plan balances, finds the AG's proposed adjustment (based upon a 12-month average of actual balances) to be a reasonable alternative.

Commission Analysis and Conclusion

At issue is which of the two proposed methodologies, the Company's forecast balances or the AG's proposal to use averaged actual balances to update and revise the forecast balances, is a more appropriate forecast for Budget Payment Plan balances. The Company asserts the superiority of its projected figures, and opposes the AG's proposed adjustments as selective and without merit. Conversely, the AG argues for the use of averaged actual balances when available to update and revise the forecast balances, a position with which the Staff concurs. The Commission accepts the AG's proposed adjustment.

Nicor bears the burden of proof regarding justness and reasonability of rates upon the utility, pursuant to Section 9-201(c). As a threshold matter, the Commission finds wholly unpersuasive Nicor's repeated argument that the proposed adjustment does not merit adoption because it is "selective." AG witness Effron argues that the correction of a faulty method of forecasting, when a superior method is available, does not constitute a selective update. The Commission agrees.

The key issue is whether the averaged actual balance provides a more just and reasonable estimate of the future balance than does Nicor's projected amounts. The Commission agrees with the AG that, in this instance, use of averaged actual balances is more likely to be objective, unbiased, and likely to avoid perpetuating past forecasting errors. In the instant case, the use of the 12-month averaged actual balances would eliminate perpetuating Nicor's $40 million forecasting error for May 2004. The record demonstrates that the AG's budget payment balances are more typical of the Company's experience than Nicor's projections and, in the Commission's view, represent a better estimate of future balances.

In summary, the Commission finds that Nicor failed to meet its burden of proof of demonstrating why use of projected balances represents a more just and reasonable method, when actual balances for the Budget Payment Plan are readily available for the previous 12-month period and correct an obvious flaw in the Company's projections. Likewise, the Commission finds appropriate the changes in Budget Payment Plan Interest Expense which result from this adjustment of the Budget Payment Plan Budget credit balance.

Therefore, the Commission finds that Nicor's proposed Budget Payment Plan credit balance of $60,965,000, should be increased to $83,427,000 (as proposed by the AG, and supported by Staff). Accordingly, Nicor's rate base should be reduced accordingly.

Customer Deposits

Nicor

Nicor has calculated customer deposits in the amount of $23,711,000 based on a 12-month average. This is based on its forecast as of December 31, 2005. The AG has proposed to increase this amount to $27,259,000. Nicor argues that AG witness Effron has arbitrarily decided to raise this amount despite providing no valid rationale for doing so.

AG

The AG has proposed an increase to customer deposits in the amount of $3,548,000. Nicor used 2003 actual figures for 2004 to create its 2005 forecast. Now that the 2004 actual figures have become available, the AG contends that they reveal a distorted 2005 forecast. Nicor anticipated a drop in customer deposits not observed in the 2004 actual figures. On the contrary, actual figures show that there was a gradual increase. The Commission should adopt a customer balance forecast based on actual numbers versus company projections which are not supported by the actual numbers.

Staff

In the interest of narrowing the issues Staff has withdrawn its proposed adjustment. However, while Staff does not take issue with the Company's proposal for customer deposits, Staff supports the use of actual balances. Staff maintains that using actual balances is superior to using the Company's projection and therefore endorses the AG's proposed adjustment.

Commission Analysis and Conclusion

At issue here is the method used in determining the amount for customer balances in the forecast test year. Nicor contends that its calculations are most appropriate. The AG, with Staff concurring, has proposed an increase to customer deposits in the amount of $3,548,000, calculated using 2004 actual numbers. The Commission accepts the AG's proposed increase.

In creating its forecast, Nicor relied upon figures which proved erroneous. Nicor expected a drop in customer deposits while the actual numbers showed a gradual increase. In this case, the actual 2004 data demonstrate that Nicor's forecast balance of customer deposits is understated. Contrary to Nicor's argument, the Commission does not consider this to be a selective revision. Instead, the Commission finds that the AG has demonstrated that Nicor's projection with respect to this item is unreasonable. Accordingly, the Commission adopts the AG's proposal on customers deposit and the corresponding adjustment to interest on customer deposits in its entirety. The Appendix to this Order shows this adjustment as a reduction to rate base.

Uncollectibles Reserve

Nicor

Nicor asserts that CUB/CCSAO witness Mierzwa presents a novel contention that the uncollectibles reserve should be treated as a rate base deduction. Both Nicor and Staff (*see* Staff Ex. 10.0, 25:502 – 26:516) agree that the uncollectibles reserve is an accounting accrual rather than cash. It is not a ratepayer-supplied source of funds, so the proposed adjustment should be rejected. According to both Nicor and Staff, the 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.

Staff

Staff agrees with Nicor that this adjustment should be rejected.

CUB/CCSAO

According to CUB/CCSAO, Nicor accrues an estimate of its anticipated uncollectible expense to an uncollectible reserve account. Delinquent customer accounts are initially written-off and deducted from the uncollectible reserve, and subsequent recoveries of delinquent amounts are added back to the uncollectible reserve. The difference between write-offs and recoveries represents Nicor's actual uncollectible expense.

Nicor's uncollectible reserve balance represents the difference between the amount charged to expense for anticipated uncollectible revenues, and actual amounts not collected. CUB/CCSAO contend that the amount charged to expense is collected in rates, and therefore represents a source of ratepayer funds. The reserve accordingly should be reflected as a reduction to rate base. In the alternative, CUB/CCSAO argue that the uncollectible expense for ratemaking purposes should be reduced to reflect a normalized level of actual net write-offs based on historical experience.

CUB/CCSAO argue that Nicor's accruals to its uncollectible reserve have consistently exceeded its actual uncollectible expense, and forecasts that Nicor's uncollectible reserve balance will be $24.2 million by the end of the test year. This represents a ratepayer-supplied source of funds because Nicor bases its ratemaking claim for uncollectibles expense on its reserve accruals, rather than on its actual net write-offs. Accordingly, the uncollectible reserve should be reflected as a reduction to rate base.

Commission Analysis and Conclusion

At issue is whether the uncollectibles reserve should be deducted from rate base. The Commission finds that, in this case, the reserve represents an accounting accrual rather than an amount of additional ratepayer supplied funds. The effect of the adjustment would be an improper reduction to rate base. Based upon the record of this proceeding, the Commission finds that the facts of the instant case do not support the adjustment proposed by CUB/CCSAO.

Commission Conclusion on Rate Base

Based on the gas utility rate base as originally proposed by Nicor along with the conclusions *supra*, the gas utility rate base for Nicor approved for purposes of this proceeding is $1,270,316,000. The rate base may be summarized as follows:

Approved Rate Base
(In Thousands)

Gross Utility Plant	$ 3,977,365
Accumulated Provision for Depreciation and Amortization	(2,240,283)
Net Plant	1,737,082
Additions to Rate Base	
Materials and Supplies	4,313
Gas in Storage	94,565
Retirement Benefits, Net	(97,855)
Deductions From Rate Base	
Construction Work in Progress Subject to AFUDC	(31,115)
Accumulated Deferred Income Taxes	(270,248)
Customer Deposits	(27,259)
Budget Payment Plan Balances	(83,427)
Regulatory Tax Liability	(40,828)
Investment Tax Credits	(9,296)
Reserve for Injuries and Damages	(1,597)
Customer Advances for Construction	(4,019)
Rate Base	$ 1,270,316

The development of the overall gas utility rate base adopted for purposes of this proceeding is shown in the Appendix to this Order.

III. EXPENSES

PGA and ECR Adjustment

Staff and Nicor agreed to remove the PGA and Coal Tar Rider revenues and the associated costs from base rates. These revenues do not impact the Company's base rates.

Lobbying Expense

Staff proposed an adjustment to disallow expenses related to lobbying activities included in Nicor's Outside Professional Services. The Company agreed to this adjustment.

Promotional & Goodwill Activities, and Matching Gift Program

Staff proposed adjustments to disallow expenses of a promotional or goodwill nature, and charitable contributions. The costs of these programs shall be borne by shareholders. Nicor agreed with these adjustments.

Injuries & Damages Expense

Staff withdrew its proposed adjustments to Injuries & Damages Expense. No other party has proposed adjustments regarding this issue.

Depreciation Expense

The methodology for calculating the test year level of depreciation expense is not contested and depends on conclusions reached on other issues related to utility plant. The Appendix attached to this order shows the resulting adjustment to test year depreciation expense that is adopted.

Gross Revenue Conversion Factor

The Gross Revenue Conversion Factor ("GRCF") contained in Nicor's original filing used a state income tax rate of 7.5%. Staff and the AG assert that the state income tax rate should be 7.3%. Nicor concurred with this proposed change. The GRCF approved herein, as reflected in the Appendix attached hereto reflects a state income tax rate of 7.3%.

Income Tax Expense

All parties that addressed this particular issue agree that the applicable tax rates are uncontested. Rather, what are at issue are the respective proposed adjustments to net rate base, operating expenses, and the rate of return, all of which are addressed elsewhere in this order. Consistent with its determinations of those underlying issues, the appropriate adjustment to income tax expense is shown in the Appendix to this Order.

Payroll Taxes

The AG and Staff support an adjustment to Payroll Taxes consistent with their respective positions on the Incentive Compensation and Payroll Expense issues. If those adjustments are adopted, Staff and the AG assert the corresponding adjustments to Payroll Taxes are reasonable. Nicor notes that there are no independent payroll tax issues, and maintains that the adjustments to both payroll tax and the underlying issues are without merit and should be rejected. The Commission notes that the outcome of this issue derives from the Incentive Compensation and Payroll Expense issues. The underlying issues are addressed *infra*; the Appendix to this Order reflects the appropriate adjustment to Payroll Taxes.

Interest Synchronization

All parties that addressed this particular issue agree that the interest expense is the product of net rate base (*see supra)* and cost of debt (*see infra)*. In other words, the underlying methodology in computing the appropriate interest synchronization adjustment is uncontested. Consistent, therefore, with its determinations of those underlying issues, the appropriate adjustment for interest synchronization is shown in the Appendix to this Order.

Industry Association Dues

Nicor

Staff witness Pugh recommends the disallowance of $93,000 for industry association dues. Nicor asserts this proposal should be rejected. According to Nicor, Ms. Pugh has distorted the meaning of "goodwill or institutional advertising." These associations include chambers of commerce, organizations of governmental bodies, and local economic development groups. Nicor witness Suppes opines that recovery of dues for the aforementioned organizations are supported by the Public Utilities Act, as membership better serves the customer and community. Ms. Suppes asserts that the memberships are not for the improvement of the image of the utility, and therefore should not be excluded.

Staff

Staff proposes removal of dues paid to certain community organizations because they are promotional, goodwill or institutional in nature. Ms. Pugh testified that membership in such organizations promotes the corporate image, but has nothing to do with providing utility service. Such dues should be characterized as promotional in nature, because the Company receives promotional benefits in return for payment of dues. Therefore, the ratepayers should not bear the burden of such expenses. Staff concedes the recovery of dues to the Midwest Energy and Southern Gas Association is appropriate because these organizations are associations of energy companies and a valuable source of information for Nicor.

Commission Analysis and Conclusion

Nicor has included industry association dues in its operating expenses. Staff proposes to reduce operating expenses by $93,000 because it believes certain costs should not be imposed on ratepayers. The Commission agrees with Staff, and finds that the removal of certain community organizations from Nicor's utility operating expenses is proper.

Certain organizations are promotional in nature, and should not be included in the operating expenses paid by ratepayers. Nicor asserts that Staff witness Pugh has misinterpreted the meaning of promotional or institutional advertising. The Commission disagrees. The onus is upon Nicor to establish how membership in certain associations is necessary to the provision of utility service. The Commission finds that Nicor failed to do so. The Commission also agrees with Staff that membership in Midwest Energy and Southern Gas Association should be recoverable through the Company's operating expenses. These associations are sufficiently related to the provision of utility service. Accordingly, industry association dues shall be reduced in the amount of $93,000 as shown in the Appendix attached hereto.

Social and Service Club Dues

Nicor

Nicor opposes Staff witness Pugh's recommendation for the disallowance of $85,000 in dues paid for social and service clubs. Nicor seeks the inclusion of said dues into the operating income statement. The Company avers that its participation in such groups benefits the community and service to customers. Nicor further contends that Ms. Pugh's argument that participation in such groups is a "promotional and goodwill practice" distorts the legal definition. For these reasons, Nicor requests that the Commission deny Staff's proposal to disallow its social and service club dues.

Staff

Staff witness Ms. Pugh advocates the exclusion of social and service club dues from Nicor's operating income statement, in the amount of $85,000. Ms. Pugh maintains that such expenses should be removed because they are a promotional and goodwill practice. Additionally, she contends that, although such groups allow both corporate and employee contact in the business community, participation in these groups is not part of providing utility service. Staff asserts that the organizations identified by the Company in Schedule C-6, pages 9-11, are not related to providing utility service. Instead, they promote the image of Nicor. Staff cites Docket 90-0169, at 20, in which the Commission stated that it understood the importance of a utility company belonging to such organizations, but ruled that the shareholders should bear such expense. (*See also* 99-0119/99-0131.) Therefore, Staff seeks Commission approval of its proposed adjustment to social and service club dues.

Commission Analysis and Conclusion

Nicor has included in its operating income statement dues for various social and service clubs. The Company predicates its argument that participation in such groups is intended for the betterment of the community and the customer. Staff takes issue with Nicor's claim, contending that such participation does not serve ratepayers and should not be at their expense. The Commission agrees with Staff that shareholders should bear this expense.

Section 220 ILCS 5/9-225 of the Act states the following:

> In any general rate increase requested by any gas or electric utility company under the provisions of this Act, the Commission shall not consider, for the purpose of determining any rate, charge or classification of costs, any direct or indirect expenditures for promotional, political, institutional or goodwill advertising, unless the Commission finds the advertising to be in the best interest of the Consumer….

Nicor must establish how its participation in such clubs benefits ratepayers before saddling them with the expense. While Nicor has disagreed with Staff witness Pugh's claims, it has failed to offer persuasive reasoning as to why the Commission should deviate from previous Orders and adopt Nicor's position. Accordingly, the Commission finds in favor of Staff's proposed adjustment to the social and service club dues.

Office Supplies Expense

Nicor

Nicor has included $23,633,000 for office supplies and expenses (Account 921) in its operating income statement. The Company opposes the AG's recommendation to reduce this amount by $5,067,000. Nicor claims that the costs assumed under office supplies and expenses are prudent and reasonable, and include necessary expenses such as office supplies and telephone.

Nicor disputes AG witness Effron's characterization that office supplies and expenses are inflated. Nicor contends that they contain an array of costs, including those for IT, risk management, oversight activities, compliance with the Sarbanes-Oxley Act, and FERC compliance. Finally, Nicor asserts that Mr. Effron ignores the undisputed fact that expenses are on track as of March 31, 2005 and will exceed the forecast budget by approximately $500.000. Nicor therefore asserts that the Commission should deny the AG's proposal.

AG

The AG has proposed a reduction to Nicor's office supply and expenses (Account 921) in the amount of $5,067,000. In the 2005 test year, Nicor forecast a balance of $23,633,000 for office supply and expenses. That number is 40% over that actually amount expended in 2004, which was $16,824,000. Although Nicor only accounted for a 10% increase in its test year, office supply and expenses actually decreased, based on 2004 figures. This variance in the 2004 figures affected the 2005 figures, resulting in a 40% increase for an amount of $6,809,000. Nicor witness Gomez never offered any accounting for this error. Additionally, Mr. Gomez characterized the AG witness Effron's calculation as inaccurate, yet was unable to cite a single inaccuracy. Mr. Effron has proposed an annual increase to Account 921 of 4%, with 2.5% allowed for annual inflation and 1.5% for system growth. When arriving at this number, Mr. Effron escalated the actual 2003 Account 921 expense of $17,165,000 by 4% annually to project a test year forecast of $18,566,000. The actual 2004 figures reveal an expense decrease to $16,824,000. Despite this decrease, Mr. Effron retained the 2003 figures for a 10% increase over the 2004 actual expenses. The AG urges the Commission to reduce Nicor's forecast of office supplies and expense to reflect actual numbers incurred in 2004.

Staff

Staff supports the AG's recommendation to adjust office supplies and expenses. Staff assents with AG witness Mr. Effron that a 37% increase to office supplies and expenses is excessive and unsupported. Therefore, Staff agrees with the AG's adjustment to office supplies and expenses.

Commission Analysis and Conclusion

Nicor has proposed $23,633,000 for test year office supplies and expenses. The AG recommends reducing this amount to $18,566,000; Staff concurs. The 2004 figures provide the most useful proxy for the test year level of office supplies and expenses. In light of the substantial variance in 2004, the Commission is not persuaded by Nicor's forecast level of expenditures for the test year. Instead, the Commission finds that the AG's adjustment is reasonably calculated. It therefore is adopted.

Branding Expense

Nicor

Nicor has included in its proposed operating income statement operating expenses of $339,625 described as branding. This amount represents the Company's allocated share of expenditures by its corporate parent, Nicor, Inc., for corporate communications activities. Nicor opposes any proposed exclusion of branding expenditures as an inappropriate reduction of its revenue requirement.

The Company asserts that the branding expenditures at issue provide clear and tangible benefits to Nicor customers. According to Nicor, one of the principal ways in which branding expenditures are expended is to inform and educate customers and the community on important issues, such as gas cost, financial assistance, and safety.

In its testimony, Nicor argues that the informational and educational functions of the branding expenses is evidenced by the Company's participation in energy fairs geared toward low-income consumers, fire department open houses, and the "Nicor in the Schools" program. (Nicor Ex. 23.0). Nicor asserts that consumers also benefit from other activities included in the branding expenditures, such as market intelligence gathering, pricing forecasts to enhance the Company's ability to meet customer needs, educational information available online at the Nicor web site, and distribution of energy-efficiency information through corporate sponsorship programs. (*Id*.)

AG

The AG proposes the exclusion of $339,625 of advertising expense described as branding. The AG argues that these branding expenses are not necessary for the provision of utility service and should not be included in the Company's revenue requirement. Instead, the AG asserts that the purpose of the branding expenditure is to improve the corporate image and reputation of Nicor, Inc. Moreover, the AG states that the Company has failed to meet its burden to establish that the branding expenditures provide any benefit to customers.

Staff

Staff concurs with the AG's proposed exclusion of branding expense from the Company's revenue requirement. Staff states that the purpose of these branding expenditures appears to be to improve the corporate image and reputation of the parent Nicor, Inc., and therefore Staff agrees that the AG's proposed adjustment is reasonable.

CUB/CCSAO

CUB/CCSAO joins the AG's proposed exclusion of branding expenses from the Company's operating expenses. First, CUB/CCSAO argue that Nicor has failed to present an adequate case for recovery of its branding expenses. Second, CUB/CCSAO assert that such branding expenditures blur the line between the utility and its unregulated affiliates. Finally, CUB/CCSAO take the position that, despite Nicor's claims that branding expenses are intended to inform and educate consumers, any such benefit is secondary to its primary goal of promotion and sales of products and services of the Company's unregulated affiliates.

Commission Analysis and Conclusion

At issue is whether Nicor's branding expenses are properly recoverable as a form of advertising expense. The Company repeatedly asserts that all of the branding expenses it seeks to include in its revenue requirement are informational and educational in nature, and thus in the best interest of consumers. Conversely, the AG asserts that these expenses are promotional in nature and designed to improve the corporate image and reputation of the parent Nicor, Inc. The Commission agrees with disallowance proposed by the AG, and supported by the Staff and CUB/CCSAO.

In order to recover the branding expenses at issue within rates, Nicor must establish the alleged consumer benefit pursuant to Section 9-225(2) of the Act, which states:

> In any general rate increase requested by any gas or electric utility company under the provisions of this Act, the Commission shall not consider … any direct or indirect expenditures for promotional, political, institutional or goodwill advertising, unless the Commission finds the advertising to be in the best interest of the Consumer or authorized as provided pursuant to Subsection 3 of this section.

220 ILCS 5/9-225(2).

The Commission concurs with the AG and Staff that the branding expenditures in question are promotional in nature, rather than informational and educational. For example, the Commission finds that Nicor has failed to demonstrate adequate ratepayer benefit associated with activities such as market intelligence gathering. Nicor argues that market intelligence gathering, focusing on issues such as supply, demand and pricing forecasts, "will enhance its ability to serve customer needs now and into the future." (Suppes Reb., Nicor Ex. 23.0 at 9.) The Commission is not persuaded that market intelligence gathering and other branding expenditures benefit ratepayers in any way. Such expenses therefore should not be borne by ratepayers.

Additionally, the Commission agrees with the AG, Staff and CUB/CCSAO that the Company has not adequately demonstrated that the branding expenditures should be borne by ratepayers when, at least in part, those branding activities promote sales of products and services of the Company's unregulated affiliates. The Commission concurs that branding is largely a pretext for promotional purposes, which chiefly benefit the Company's unregulated affiliates.

Accordingly, the Commission finds that Nicor failed to sufficiently justify the branding expenditures being borne by ratepayers. Nicor, therefore, is not entitled to recovery of the $339,625 portion of its advertising expenses attributable to branding expenditures.

Storage Gas Losses (2% Withdrawal Factor)

Nicor

Nicor Gas currently recovers a 2% withdrawal factor from Sales customers through Rider 6, Gas Supply Cost, and from Transportation customers through the lost-and-unaccounted-for adjustment. According to Nicor, this recovery methodology has been in place for decades.

Staff's proposal notwithstanding, Nicor Gas believes, given the volatility of these expenses, that the most efficient method of reflecting the expenses associated with the 2% withdrawal factor is to continue Nicor Gas' current process of passing the costs through the Gas Supply Cost to Sales customers and through the lost-and-unaccounted-for adjustment to Transportation customers. The net impact of this approach is the recovery of current costs from both sales and Transportation customers on a current basis.

Nicor points out that there is a substantial impact on base rates in the event the Commission adopts Staff's final proposal of moving all expenses of the 2% withdrawal factor, as to Sales customers only, to base rates, while permitting Nicor Gas to continue to recover the 2% withdrawal factor as to Transportation customers through the lost-and-unaccounted-for factor. In this instance, the correct amount of the adjustment to base rates would be an increase in operating expenses of $16,347,000 times 61%, or $9,971,670. Nicor believes Staff's final revised revenue requirement Schedules (Struck Reb., Staff Ex. 10.0 Revised, Schedule 10.01 Revised, page 1, column (c), line 8, and Schedule 10.02 Revised, page 1, column (f), line 8), which show a figure of $12,879,000, to be in error since the figure of $12,879,000 is too low for Staff's original proposal, and too high for Staff's final proposal.

In short, Nicor believes the Commission should approve and retain Nicor Gas' current method of handling the 2% withdrawal factor, which is proper and which is in the interests of customers and the utility alike.

Staff

Staff proposes an adjustment to include the cost of storage gas losses in Account 823 (Gas Losses), as an operating and maintenance cost, instead of recovering the cost through the PGA charge. Staff's proposal is to move to base rates the expenses associated with the 2% withdrawal factor as to Sales customers, while to continue to permit Nicor Gas to recover the expenses associated with the 2% withdrawal factor through the lost-and-unaccounted-for adjustment as to Transportation customers. (*See* Staff Init. Br. at 36-38.) Staff also is now using a correct figure for the Sales customer (base rate) amount, assuming that the figure is not to be updated as of March 31, 2005.

Staff contends that the Sales customer-related expenses associated with the 2% withdrawal factor should no longer be included in Rider 6. Staff does not believe that the Company's reason, that these expenses have been recovered in such a method for decades, is sufficient. Staff argues that "determining the amount related to gas storage losses should be calculated only on Company-owned gas in Company-owned storage reservoirs. The ratepayers should not pay for storage losses on third party gas." (Staff Init. Br. at 37.)

Additionally, Staff contends that continued inclusion of such expenses in a Rider 6 recovery mechanism would constitute a violation of the Commission's rules. Specifically

Staff cites to 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")).

Staff points to the testimony of Company witness Gorenz (*See* Nicor Ex. 41.0, p. 22, lines 470-473), where he describes the 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. 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.

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. (Staff Init. Br., Appendix A, Schedule 2, p. 1, column f.) Staff, therefore, 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.

Commission Analysis and Conclusion

The issue here is whether it is appropriate for the Commission to allow Nicor to continue to recover Sales customer-related expenses associated with the 2% withdrawal factor via Rider 6. The Commission does not believe it is and finds Staff's position on this issue reasonable.

The Commission's administrative rules are instructive. Specifically, Code Part 505 sets forth the Uniform System of Accounts for Gas Utilities. Account 823, designated "Gas losses," is classified as an operating and maintenance expense and provides as follows:

> 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.* (*See* Paragraph G of Account 117, Gas stored underground – Noncurrent.) 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.

83 Ill. Admin. Code § 505.8230 (emphasis added).

The Commission agrees with Staff that ratepayers should not pay for storage losses on third party gas. Nicor advances two arguments as to why its current method of recovering expenses associated with the 2% withdrawal factor should be left undisturbed. First, Nicor contends that its current method of handling the 2% withdrawal factor is long-established. Second, Nicor believes that due to the volatile nature of these expenses, which are directly related to the cost of gas, the most efficient method of reflecting these expenses is to continue Nicor Gas' current process of passing the costs through Rider 6.

We disagree and find that Nicor has failed to carry its burden on this issue. The fact that expenses associated with the 2% withdrawal factor have been recovered in this manner "for decades" is not a sufficient reason for why it should continue. Regardless of what transpired in previous proceedings, the Company's proposal appears to be in direct violation of a Commission rule, Part 505, and the Commission cannot allow this to continue. Moreover, Nicor characterizes these expenses as "volatile" in nature yet could not point to anywhere in the evidentiary record where that volatility was clearly established. The Commission also notes that Nicor Gas witness Harms conceded on the record that "the method she [Staff witness Ms. Pugh] has proposed is the best choice of the other alternatives." (Nicor Gas Ex. 27, at 7, ll. 151-153)

In sum, Nicor has failed to meet its burden that continuing to recover 2% withdrawal factor from Sales customers through Rider 6, Gas Supply Cost, is just and reasonable. Staff's position is adopted *in toto*. The Commission approves 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 Nicor is directed to cease its current practice of recovering storage gas losses through Rider 6.

Corporate Benefit Plan Expense

Nicor

Nicor Gas has included in its proposed base rate operating expenses $2,206,000 of expenses billed to it by Nicor Inc. for administering Nicor Gas' corporate benefit plans. Nicor asserts that it "properly assembled this forecast through the work of a great number of trained people." (Nicor Init. Br. at 68.) Moreover, Nicor argues that it has convincingly demonstrated, via witness Bacidore's testimony that the Company is on track with this forecast. Nicor takes exception with AG witness Effron's proposal to reduce these expenses by $1,103,000. Nicor argues that the AG's proposal is "another inappropriate attempt to make a selective update of Nicor Gas' test year forecast." (Nicor Init. Br. at 69.) According to the Company, adopting the AG's proposal would send a "negative message to both employees and the financial community." (*Id*. at 69.) Nicor, therefore, urges the Commission to reject the AG's proposed disallowance.

AG

The AG, via its witness Mr. Effron, proposes eliminating the effect of increasing the payout ratio from 50% to 100% from the forecast of test year operation and maintenance expense, reducing test year expenses by $1,103,000.

The AG refutes the Company's reference to Mr. Effron's adjustment as a "selective update" as a mischaracterization. The AG believes that Nicor's assumption that its payout ratio, which in 2003 was at 50% of maximum benefits, would increase to 100% in 2004 and stay there in 2005 is faulty and unpersuasive. The AG points out that in 2003, the actual expense for these benefits was a 50% payout of the maximum benefits. Additionally, the AG highlights the fact that the five-year average of years preceding the test year for these types of expenses was approximately 50%, the same as the ratio in 2003, the year referred to by Mr. Effron in making his proposal.

According to the AG, the Company has failed to provide any compelling reason to believe that the forecast payout ratio of 100% is any more likely than the actual payout ratio of 50% experienced in 2003. Finally, the AG points out that Staff also found Mr. Effron's adjustment to be reasonable. The AG, therefore, urges the Commission to reject Nicor's mischaracterizations and find a Corporate Benefit Plan Expense based upon a payout ratio of 50%.

Staff

Staff, while not proposing its own adjustment to the Company's corporate benefit plan expense figure, finds AG witness Effron's adjustment reasonable.

Commission Analysis and Conclusion

Nicor Gas has included in its proposed test year operating income statement $2,206,000 of expenses for the administration of its corporate benefit plans. AG witness Effron has proposed to reduce these expenses by $1,103,000. Staff supports the AG's proposed disallowance. The Commission agrees with the AG's proposed disallowance.

The Commission finds the fact that in the five years preceding the test year, the payout ratio *never* reached 100% (Tr. 414:14-22) compelling and persuasive. Moreover, as the AG points out, it appears that the average for that five year period prior to the test year was approximately 50%, the same as the ratio in 2003, the year referred to by Mr. Effron in making his proposal.

The Commission disagrees with Nicor's assertion that Mr. Effron's proposal is unreasonable. In fact, Mr. Effron's proposed adjustment clearly reflects the Company's actual experience with corporate benefit plan expense over the last four years. The Company has not provided any reason to believe that the forecast payout ratio of 100% is any more likely than the actual payout ratio of 50% experienced in 2003.

In light of the evidentiary record on this issue, the Commission finds that Nicor's inclusion of $2,206,000 in corporate benefit plan expenses should be reduced to exactly half that amount. Accordingly, test year operation and maintenance expenses should be reduced by $1,103,000.

Incentive Compensation

Nicor

Staff witness Pugh proposes to disallow $6,089,000 in incentive compensation expenses, asserting that such costs do not benefit ratepayers. AG witness Mr. Effron proposes a similar disallowance. Nicor argues that their proposals should be rejected.

According to Nicor, employees consider total compensation. Nicor Gas follows a total compensation approach that considers overall employee compensation as well as its components in seeking to pay employees at the median – the 50th percentile – of the applicable labor market, in order to balance the objectives of obtaining a sufficient, qualified work force while controlling costs. Nicor maintains that incentive compensation allows it to attract and maintain a skilled workforce "that provides safe, reliable service to Nicor Gas customers, which is obviously to the customers' benefit."

(Nicor Reply Br. at 72.) Nicor asserts that no party claims that the payment of incentive compensation is imprudent or unreasonable, or that the amount paid is excessive. The proposed adjustments, according to the Company, simply seek to punish Nicor Gas for choosing incentive compensation as one of the elements of the total compensation package.

Nicor contends that Staff and the AG did not rebut Nicor's argument that the total compensation it pays has resulted in a cost-efficient gas utility. According to Nicor, Mr. Effron acknowledged that, because an incentive compensation program has financial goals, it does not necessarily follow that it benefits only stockholders, and that if a incentive compensation program is tied to cost reductions that benefit customers, then it is reasonable to include the program' expenses in the revenue requirement.

Finally, Nicor contends that, although the Commission has disallowed incentive compensation expenses in several other Dockets, that does not warrant disallowing Nicor's incentive compensation expenses. The issue, Nicor asserts, should be decided based on the record in this Docket. Ms. Bacidore testified that, while the Commission has denied incentive compensation program costs in some Dockets, it has approved it in others, including Nicor Gas' last general rate case, Docket 95-0219…" (Nicor Ex. 25.0 at 11.) Even if a disallowance is permitted, Nicor believes it should be limited to the average portion of incentive compensation actually compared to the amount funded—approximately 55% over the last five years.

Staff

Staff witness Pugh proposes an adjustment to disallow incentive compensation and associated payroll taxes related to the 2005 bonus plans, because they are dependent upon financial goals of the Company, which benefit shareholders and not ratepayers; the goals may not be met, in which case the Company would recover from ratepayers a level of cost not incurred; and the disallowance of incentive compensation is consistent with prior Commission Orders. The Company disagrees with Staff's adjustment, stating that it is arbitrary and not in the interests of customers.

Staff believes the Company's arguments should be rejected. The information provided by the Company demonstrates that the programs are based on the financial goals of the Company. These goals primarily benefit shareholders; therefore, shareholders should bear the cost.

According to Staff, 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. Staff argues that 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 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.

(93-0183, at 52.)

In addition, the Commission has expressed concern that ratepayers will have to fund the programs whether or not the targeted return on capital investment is not achieved, stating:

> The Commission is not convinced that the ratepayers are protected in the event that the targeted return on capital investment is not achieved. Ratepayers would still fund the projected levels of incentive compensation even if that level is not achieved.

(99-0534, at 9.)

Staff notes that AG witness Effron similarly proposes an adjustment to reduce payroll expense, including the elimination of incentive compensation. Staff asserts that the AG's adjustment is different from Staff's in that the AG's only includes the 2005 forecast amount expensed as Staff's adjustment includes total costs for the incentive plans, amounts expensed plus amounts capitalized. 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. (*See* Staff Ex. 12.0, Sch. 12.02.)

<u>AG</u>

The AG highlights that Nicor has increased the test year forecast for incentive compensation by 288% over the 2003 level. The AG asserts that the Commission should disallow incentive compensation because Nicor has not demonstrated that its incentive compensation program benefits ratepayers. Recovery in rates of costs associated with incentive compensation programs is routinely denied when the utility does not demonstrate any benefit to ratepayers. (*See*, e.g., 01-0432, at 42-43.) The AG asserts that Nicor has not demonstrated that its incentive compensation program can reasonably be expected to produce net benefits to ratepayers, so the Commission should not allow it to recover this expense. Shareholders, not ratepayers, should pay for the benefits that shareholders alone derive from the incentive compensation programs.

<u>Commission Analysis and Conclusion</u>

Nicor seeks to recover the costs of its incentive compensation programs from ratepayers. Staff proposes an adjustment eliminating incentive compensation expense from Nicor's operating expenses. The AG proposes an adjustment that eliminates the cost of incentive compensation expense as part of a larger adjustment to payroll expense. For the reasons that follow, the Commission accepts Staff's adjustment. The remainder of the AG's adjustment is considered separately under the heading of Payroll Expense.

Costs related to incentive compensation are recoverable in rates only if the utility demonstrates tangible benefits to ratepayers. (*See,* e.g., 03-0403 at 15 ("[T]o recover incentive compensation, the plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates."); 01-0696 at 10 (requiring evidence of "specific dollar savings or any other tangible benefit for the ratepayers"); 01-0432 (Mar. 28, 2002) at 42-43 ("the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations. … [I]f a utility is seeking to recover such projected expenses from ratepayers, the utility should demonstrate that its plan can reasonably be expected to provide net benefits to ratepayers.").) The utility bears the burden to establish that such tangible benefits accrue to ratepayers, in order to prove that the recovery of incentive compensation costs is just and reasonable. (*See* 220 ILCS 9-201(c).)

The central question is whether Nicor sufficiently demonstrated that tangible benefits accrue to ratepayers from the incentive compensation program. The Commission looks to the nature and specificity of the goals or targets which trigger incentive compensation payments. A vague allegation that ratepayers benefit from an incentive compensation program is insufficient to demonstrate savings or benefits and justify recovery of costs from ratepayers. In addition, the reasonableness of the amount to be recovered in rates may be a factor.

In the instant case, Nicor relies primarily on very general testimony to support its request for recovery. While the Company maintains that the reasonableness of the amount is unchallenged, the AG expressed concern that the test year amount requested by Nicor is almost triple the amount compared to that incurred two years earlier. With respect to the nature of the goals for which incentive compensation is provided, Ms. Bacidore testified that:

> Targets for each of those plans are established in conjunction with our financial areas and, with the exception of one plan, are based on achieving net income goals approved by the Board of Directors. The "exception" to this is in the incentive plan for managers (salary grade 7 and 8) in which 60% is based on net income and 40% of their potential payout is based on individual goals approved by the Vice President of the area, reviewed by Human Resources, and audited by internal audit.

(Nicor Ex. 9, at 8.) In essence, the cost of incentive compensation that Nicor seeks to recover is largely based on financial goals. It is unclear what might comprise the "individual goals" that are approved and reviewed by Nicor management, but the existence of such a process of approval and review suggests that documentary evidence exists that Nicor could have been offered to support its claim that the program benefits ratepayers. In any event, the Commission concludes that the majority of the incentive compensation program is based on financial goals. The Commission maintains that incentive compensation costs should be borne by shareholders rather than ratepayers when the payment of incentives is dependent upon, or triggered by, the achievement of financial goals. (*See* 93-0183 at *107.) As noted *supra*, recovery of incentive compensation in rates is contingent upon a showing of tangible benefits that accrue to ratepayers rather than other stakeholders.

Nicor argues that incentive compensation allows it to maintain a stable workforce "that provides safe, reliable service to Nicor Gas customers, which is obviously to the customers' benefit" reveals two flaws. Most importantly, it is the duty of Nicor, as a public utility, to provide safe, adequate, reliable service. If Nicor fails to meet the financial targets, or any other goals, that trigger incentive compensation payments, Nicor still has an obligation to provide safe, reliable service. Given that Nicor's incentive compensation outlays are so heavily dependent upon financial targets, the Commission does not believe this rationale is sufficient to require ratepayers to bear the cost of the payments.

Nicor also emphasizes that it attempts to pay employees at the industry median, and that incentive compensation helps the Company to accomplish this goal. Again, given the heavy dependence on financial targets in the incentive compensation program, the Commission is not swayed by Nicor's argument. Nicor further contends that no party has argued that the concept of incentive compensation is imprudent. Whether or not these arguments are correct, they do not help Nicor to meet the standard for recovery of these types of costs from ratepayers. As noted above, at issue is whether ratepayers should be responsible for funding incentive compensation through rates. Recovery of incentive compensation costs in rates requires the Company to establish that:

> the plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates.

(*See supra*; 03-0403 at 15.) Although Nicor maintains that ratepayers benefit from funding incentive compensation, the Company does not adequately quantify how ratepayers benefit. Ms. Bacidore avers that the Company is likely to file rate cases less frequently, but that alleged benefit is speculative, unsupported, and, in any event, illusory. The hope of less frequent rate cases in the future in exchange for a larger rate increase today is precisely why the Commission views with skepticism incentive compensation plans based largely on financial goals or targets.

In Nicor's last rate case, the Commission denied recovery of incentive compensation related to "cost containment, safety, reliability, and customer satisfaction goals" because Nicor did not establish that those goals were met. (95-0219 at *61.)

Furthermore, 02-0690 (at 19) disallowed incentive compensation tied to financial goals. Also, numerous cases (*see* citations *supra*) after 95-0219 have required evidence of tangible benefits to ratepayers to recover incentive compensation. Having failed to provide such evidence, Nicor can not recover incentive compensation costs from ratepayers. Nicor also cannot recover the average portion, or 55%, paid over the last five years, because it has not shown any tangible benefits accrued to ratepayers as a result of those payments. In addition, Nicor cannot use a determination in 95-0219 to avoid the necessity of providing evidence in this case that it meets the standard for recoverability of the costs in question here.

The Commission notes that the adoption of the adjustment does not force the elimination of Nicor's incentive compensation program. It merely requires that shareholders fund the cost of a program that overwhelmingly benefits shareholders rather than ratepayers. The Commission also rejects Nicor's contention that the adjustment penalizes Nicor for employing incentive compensation. The determination herein simply finds that Nicor did not demonstrate specific savings or other tangible benefits for ratepayers, and therefore, pursuant to Section 9-201 of the Act, is not entitled to recover the costs of the program from those ratepayers.

Stock Option Expense

Nicor

The AG and Staff propose to disallow $891,000 in operating expenses associated with employee stock options, asserting that these expenses do not benefit ratepayers. Nicor Gas follows a "total compensation" approach to employee compensation that considers overall employee compensation levels, and seeks overall to pay employees at the median, or 50th percentile, of the applicable labor market. Nicor contends that its approach balances the objectives of obtaining a sufficient, qualified work force while controlling costs.

Nicor argues that the proposed adjustment inappropriately focuses on a single element of the total compensation package, while ignoring the adverse impacts on customers of driving down total compensation. Stock option expense, the Company avers, is one element of the total compensation package. In order to get total compensation back to the 50th percentile if a particular form of compensation is disallowed and eliminated, Nicor Gas raises other elements of the total compensation package. The adjustment therefore would not reduce total operating expenses; it would only interfere with Nicor's compensation package. Nicor maintains that the Commission therefore should reject the proposal to disallow Nicor Gas' employee stock options expenses.

AG

Nicor includes $891,000 in its forecast of test year expenses as a stock options expense. Absent a showing by Nicor that its stock options expense in some way benefits rate payers, the Commission should remove $891,000 from Nicor's test year operation and maintenance expense. The AG also notes that Nicor's inclusion of a stock options O&M expense in its 2005 forecast of operating and maintenance expense represents a change in accounting practice, as stock options have not been charged to expense prior to 2005. According to the AG, stock options reward employees based upon the increases in the price of common stock shares. An increase in the value of shares benefits shareholders, not ratepayers. Therefore, it is unreasonable to assign the costs of the stock options to ratepayers.

Nicor witness Bacidore stated that stock options expense should be treated similar to Nicor's expense for incentive compensation. (Nicor Gas Ex. 25 at 13, ll. 277-279.) Mr. Effron agrees that similar treatment is appropriate, and that both stock options expense and incentive compensation expense should be excluded from the cost of service, if they are structured to reward employees for serving the interests of shareholders rather than ratepayers. Similar to incentive compensation, the Company has provided no evidence to suggest that including a stock options expense in its cost of service will benefit ratepayers. The AG also notes that Staff concurs that its adjustment is appropriate.

Staff

The Company included $891,000 of stock option expense in the forecast test year operation and maintenance expenses. Staff supports the adjustment suggested by AG witness Effron to eliminate the expense for the fair value of stock options from utility cost of service. Stock options reward employees based on the increase in the price of common stock shares. This is a goal that benefits shareholders, not ratepayers. Staff concurs that it is unreasonable to assign the costs of the stock options to ratepayers if the benefits of increased share prices inure to shareholders. Staff witness Pugh concurred with AG witness Effron's adjustment, and recommends that the Commission approve the adjustment to reduce Stock Option Expense for $891,000.

Commission Analysis and Conclusion

The Commission concurs that stock option expense is a form of incentive compensation expense. If the cost of stock option expense is to be recovered in rates, it therefore must satisfy the same test as other incentive compensation programs. Accordingly, to recover stock option expense in rates requires the Company to establish that:

> the [stock option] plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates.

(*See supra*; 03-0403 at 15.) In this case, Nicor fails to demonstrate that specific dollar savings or other tangible benefits accrue to ratepayers. Accordingly, the AG's proposed adjustment is adopted. The Commission notes that the adoption of the adjustment does not eliminate the stock option program, it merely requires that shareholders fund the cost of a program that overwhelmingly benefits shareholders rather than ratepayers.

Payroll Expense

Nicor

AG witness Effron proposes a revised reduction to payroll expense of $502,000 included in OO&M expenses based on his assertions relating to employee headcounts. Nicor states that Mr. Effron's proposed adjustment is unwarranted, and that there is no reason for rejecting Nicor Gas' forecast. Nicor asserts that its 2005 operating expenses are on target, and OO&M expenses now are expected to exceed the budgeted amount by about $500,000.

AG

The AG asserts that Nicor's forecast of test year payroll expense should be decreased by $5,769,000. (*See* AG Ex. 1.3, Sch. C-2.1.) The proposed adjustment begins with Nicor's actual payroll expense for 2004, excludes incentive compensation expense, and applies the 3.5% wage rate increase factor provided by Nicor to forecast the 2005 test year payroll expense. (*See* Nicor 285 Filing, Schedule C-11.1; Nicor Ex. 9.0 at 11.) The AG also urges the removal of incentive compensation within this adjustment.

In addition, Mr. Effron's forecast disregards Nicor's representation that there will be a 50-employee increase in 2005. According to the AG, Nicor witness Bacidore agreed at trial that a 50-employee increase in 2005 is not supported by an upward trend in recent years. Ms. Bacidore referenced only four examples of new employee positions: a senior locator, a leak survey specialist, a senior operations mechanic, and a watch and protect locator. (Tr. 412; Nicor Ex. 25.0 at 12.) The AG therefore contends that Nicor does not justify its increase in employee count, and urges the Commission to accept Mr. Effron's adjustment reducing payroll expense by $5,769,000.

Staff

Staff states that AG witness Effron made two adjustments to payroll expense, one based on the actual 2004 employee level, and the other removing incentive compensation expenses. According to Staff, Nicor assumed that the employee count would increase by 50 in 2005. Mr. Effron noted that the number of employees in recent years has not shown any noticeable upward trend, however, and the Company did not demonstrate that the assumed increase of 50 employees in the 2005 test year was reasonable. Therefore, the increase should not be included in determining the 2005 payroll expense. Staff agrees that Mr. Effron's adjustment to remove costs with the assumed increase of 50 employees is reasonable.

Commission Analysis and Conclusion

The two main components of the adjustment proposed by the AG are the removal of incentive compensation costs and the removal of costs associated with the 50 additional employee positions. The Commission already has dispensed with the issue of incentive compensation costs. (*See supra*.) The alleged 50 additional employees remain at issue. The Commission notes that the four titles listed by Nicor witness Bacidore and cited by the AG are merely new job titles filled by existing employees:

> Existing employees filled the newly created job classifications leaving behind open positions to be filled by new employees. The new job classifications include a senior locator, leak survey specialist, senior operations mechanic and watch and protect locator.

(Nicor Ex. 25.0 at 12.) In the Commission's view, the record lacks adequate evidence that Nicor has filled, or intends to fill, the "open positions." Indeed, the AG has demonstrated that, on a monthly basis, headcount remained stable in the first quarter of the 2005 test year compared to 2004 levels. Nicor did not provide any documentation to support its claim that it would hire approximately 50 additional employees during the test year. If Nicor had definite rather than speculative hiring plans, there would be no shortage of documents related to the planning, announcement, or hiring for 50 new positions. Nicor, however, did not offer even one such document into the record. The Commission finds that recovery of costs for the alleged 50 additional employees is unsupported and must be denied. That portion of the AG's proposal therefore is adopted.

Uncollectibles Expense: Loss Factor

Nicor

Nicor Gas proposes an updated uncollectibles loss factor of 1.40%. The Company asserts that its updated loss factor was calculated using the most recent available data, and best accounts for the impact of rising natural gas prices on uncollectibles expense. Staff witness Mr. Struck has accepted the 1.40% loss factor. AG witness Mr. Effron asserts that the loss ratio should be 1.30%, based on historical averages.

According to Nicor, Mr. Effron's proposal does not recognize significant increases in uncollectibles expense. Nicor criticizes Mr. Effron's calculation for using historical averages to predict future uncollectibles expense when the historical data indicated that an upward trend in uncollectibles; and for comparing projected net charge-offs to current revenues to determine the uncollectibles ratio. Because uncollectibles are trending upward, the historical average will under-represent the test year level of uncollectibles. Nicor also argues that the use of current revenues to determine the uncollectibles ratios of historical uncollectibles levels is inappropriate. The Company contends that projected net charge-offs track most closely with revenues eight months earlier; comparison of projected net charge-offs to current revenues results in an under representation of the true uncollectibles ratio. Nicor states that it experienced a 1.40% uncollectibles expense ratio for the first quarter of 2005 and even began the second quarter of 2005 experiencing a 1.45% uncollectibles expense ratio. The 1.40% uncollectibles ratio, as used by Nicor and Staff, more accurately reflects the uncollectibles ratio Nicor is experiencing during the test year.

Staff

In its rebuttal testimony, the Company proposed to revise its test year uncollectibles expense from that presented in its direct testimony to reflect a 1.40% loss ratio rather than a 1.30% loss ratio. The Company indicates that in the first quarter of 2005, it began recording uncollectibles expense at 1.40% of revenues and has increased this to 1.45% of revenues for the second quarter of 2005. Staff reflected the Company's revised uncollectibles amounts in its schedules. (ICC Staff Ex. 10.0-Revised, Sch. 10.07and 10.08-Revised)

AG

Nicor proposes to modify its pro forma uncollectible accounts expense included in the test year cost of service to reflect a higher loss ratio. The AG argues that the Commission should reject Nicor's proposed loss ratio because it is inconsistent with the

Company's historical loss ratios. Nicor's use of a loss ratio of 1.40% increases its 2005 uncollectible accounts forecast by $2,058,000, including the uncollectible accounts expense related to the cost of gas. A loss ratio of 1.40% is too high because Nicor's ratio of net charge-offs to revenues from 1999-2004 never reached 1.40%. The AG notes that, for the five-year period 2000-2004, the average loss ratio for Nicor was 1.11%; for the most recent three years, it was 1.25%, and in 2004 it was 1.32%. Considering this history, the AG argues, there is no reason to suspect that the loss ratio will reach 1.40% in 2005. The AG points out that a five-year average of the ratio of net charge-offs to revenues was used to determine the appropriate pro forma uncollectible accounts for the revenue requirement in Docket 02-0837 and 03-0008/03-0009 (cons.).

Commission Analysis and Conclusion

The Commission finds that the loss ratio of 1.40% should be adopted. The ratios for the various periods discussed by the AG support Nicor's contention that the ratio has been increasing. Coupled with the actual data from the beginning of the test year period, the Commission believes that Nicor's proposed 1.40% rate will reflect test year conditions more closely than the AG's proposed 1.30% rate. Accordingly, Nicor's proposal is accepted.

Rate Case Expense

Nicor

Nicor's proposed rate case expense amount is uncontested. The only dispute is the proper amortization period. Nicor Gas proposed a five year amortization period, based on the approval of a five year period for this purpose in its last general rate case, Docket 95-0219. The Company avers that a five year period is also consistent with other Commission Orders in other recent rate cases.

Staff

The Company proposed to amortize rate case expense over a five-year period. Staff witness Ebrey proposed a $268,000 decrease to test year Rate Case Expense based on Staff's use of an eight year amortization period. Staff witness Ebrey's eight year amortization period was based upon the intervals between the rate cases filed by the Company in 1981, 1987, 1995 and the instant case in 2004. The length of time between the rate cases is six, eight, and nine years respectively, or an average of approximately eight years over the 23-year period. Based on the Company's rate case filing history, Staff's eight-year amortization period reflects the time the rates set herein are expected to be in effect.

Staff avers that, given Nicor's history, the eight year amortization period is superior to the five year period proposed by the Company due to the implications for recovering the expense. According to Staff, the five-year amortization set in the 1995 case resulted in an over-recovery by Nicor of four years worth of rate case expense, or $880,000. Staff states that there is not a mechanism to recapture excess rate case expense paid as a result of choosing too short an amortization period. In contrast, Staff notes that unamortized rate case expense may be considered in the next rate case if such a case is filed before the amortization period ends.

Commission Analysis and Conclusion

The amortization period for rate case expense is guided by the requirement that the final rates be just and reasonable pursuant to Section 9-201 of the Act. Under Nicor's proposed five year amortization period, the Commission finds a substantial likelihood that the Company will over-recover its actual rate case expense due to the lives of the rates set in each of the last several cases. Under Staff's proposal, there is a possibility that a small portion of the total rate case expense will remain unamortized at the time of the next case. In that situation, such amount may be considered during the subsequent rate case. The Commission concludes that there is a probability of an irreparable harm to consumers through an over-recovery under Nicor's proposed five year amortization proposal, and no significant harm to the Company under the eight year amortization proposal. The Commission adopts Staff's proposed amortization period of eight years for rate case expense.

Approved Operating Expenses and Revenues

Based on the gas utility operating expense statement as originally proposed by Nicor and the adjustments to operating revenues and expenses as summarized above, the total gas utility operating expenses for Nicor approved for purposes of this proceeding are $463,516,000. The operating income statement may be summarized as follows:

Approved Operating Income Statement
(In Thousands)

Base Rates Revenues	$	558,822
PGA Revenues		-
ECR Revenues (Coal Tar)		-
Other Revenues		17,752
Total Operating Revenue		576,574
Uncollectibles Expense		35,928
Cost of Gas		2,221
Storage		22,371
Transmission		4,340
Distribution		51,282
Customer Accounts		33,922
Customer Services and Informational Services		474
Sales		3,358
Administrative and General		92,151
Depreciation		154,380
Taxes Other Than Income		18,895
Total Operating Expense Before Income Taxes		419,322
State Income Tax		8,677
Federal Income Tax		32,943

Deferred Taxes and ITCs Net	2,574
Total Operating Expenses	463,516
Net Operating Income	$ 113,058

The development of the overall gas utility operating expenses adopted for purposes of this proceeding is shown in the Appendix to this Order.

IV. WEATHER NORMALIZATION

Nicor

Nicor's gas deliveries, and therefore revenues, are dependent on weather. The key weather statistic reflecting use of gas for space heating is the heating degree day (HDD). The number of heating degree days is calculated as the number of degrees Fahrenheit that the actual mean daily temperature is below 65 degrees Fahrenheit, i.e. HDD = 65 – [(High + Low)/2]. A colder winter results in more deliveries, and a warmer winter results in fewer. Weather normalization is a method of predicting expected weather for a utility's service area and building it into the rates. No party disputes that weather normalization is appropriate for setting Nicor's rates.

The dispute centers on the calculation of the normal weather—the predicted number of heating degree days—that Nicor can expect. Nicor states that a number of rate cases, including its previous rate case, used a thirty-year average of heating degree day statistics for weather normalization. Nicor proposes that a ten year average be adopted for weather normalization in the instant case. The Company asserts that its ten year average will more accurately predict the heating degree days over the period of time that Nicor's proposed rates are expected to be in effect. Staff notes that Nicor did not study averaging periods other than ten years or thirty years to evaluate whether another period was even more appropriate. Nicor witness Harms counters that it focused on the ten year period because financial markets that use weather information now use ten-year periods.

Nicor contends that its witness Herrera, an expert in statistics, found that the ten-year average predicts future heating degree days more accurately, and that no party questioned his analysis. Nicor also argues that the winter climate in its service territory has begun to warm, and is expected to continue to do so over the next several years. Nicor witness Takle believes that the changing climate makes a shorter averaging period more accurate than a longer period. Nicor states that no party contested Professor Takle's conclusions.

Nicor asserts that the ten-year average of heating degree days is 5,830 per year, and the thirty-year average is 6,072 HDDs per year. According to Nicor, setting gas deliveries based on the higher level will cause Nicor's rates for recovering the allowed base rate revenue requirement to be set too low for the number of heating degree days that Nicor believes it will experience. Nicor worries that its earnings will be between

$5.5 and $8.5 million too low under a thirty year normalization period if the weather is warmer than the normalization level.

Staff nonetheless requests the Commission to use the thirty-year average based on past practice. Nicor avers, however, that the Commission has the power to deal with each situation before it regardless of how it may have dealt previously with a similar or the same situation. (*See Citizens Util. Bd. v. ICC*, 291 Ill. App. 3d 300; 307, 683 N.E.2d 938, 945 (1st Dist. 1997); *City of Chicago v. ICC*, 133 Ill. App. 3d 435, 440, 478 N.E.2d 1369, 1373 (1st Dist. 1985).) Nicor argues that Staff offered no proof that a thirty-year average outperforms a ten-year average in predicting future deliveries, or even that a thirty-year average was scientifically or statistically sound. Staff's only witness was neither a scientist, nor a statistician, nor an engineer.

Nicor views Staff to argue that the appropriate forum to address weather averaging is a new rulemaking. The Company argues that "there has never been a rulemaking on this issue, and the Commission has no rules on weather normalization, or rules that prevent a utility from proposing any particular normalization period." (Nicor Init. Br. at 78; *see also* Nicor Ex. 28.2 (citing 83 Ill. Adm. Code § 285.5025), 28.3 (no similar rule prior to 285.5025).) Furthermore, Nicor contends that the Commission has approved different periods for normalization of weather, storm damage expenses, and amortization of rate case expenses in utility rate cases based on the facts presented in each specific case. According to Nicor, Staff relies on a "practice" of using a thirty-year weather normalization period based on its use in previous rate cases. Nicor avers that a practice that is not a promulgated rule to trump the evidence in the record of a specific case. Nicor states that it simply seeks a decision based on the evidence in the record.

Nicor urges that the testimony of its witnesses Herrera and Takle is uncontradicted, even taking Staff witness Beyer's testimony into account, and therefore concludes that the testimony of its witnesses must be given effect. (*See Bazydlo v. Volant*, 164 Ill. 2d 207, 215, 647 N.E.2d 273, 277 (1995) ("[T]he fact finder may not arbitrarily or capriciously reject unimpeached testimony. Where the testimony of a witness is neither contradicted, either by positive testimony or by circumstances, nor inherently improbable, and the witness has not been impeached, that testimony cannot be disregarded by the trier of fact."); *Thigpen v. Retirement Bd. of Fireman's Annuity and Benefit Fund of Chicago*, 317 Ill. App. 3d 1010, 1021, 741 N.E.2d 276, 284 – 85 (1st Dist. 2000) ("While an administrative agency's findings of fact are considered prima facie correct, they must still be based on the evidence, and the agency as fact finder simply cannot disregard the testimony of an unimpeached witness where the testimony is uncontradicted and is not inherently improbable.").)

Nicor sees little need for imposing a uniform weather normalization rule for both heating and cooling degree day normalization periods. The Company argues that it offered evidence demonstrating a more accurate averaging period specifically applicable to Nicor. The Company also avers that winter temperatures are warming more than summer temperatures, so any such change may not affect heating and cooling utilities to the same extent. Finally, Nicor asserts that changing the weather normalization methodology is appropriate only in a rate case context, so a decision should on the normalization period should not be deferred. (*Cf*. 05-0288 (denying weather adjustment rider).)

Staff

Illinois gas and electric utility rates are based on various factors, including, but not limited to, expected customer usage. A forecast for customer usage is based in part on expected weather. A forecast based on colder weather and higher therm sales will produce lower per-therm rates *ceteris paribus* than a forecast based on warmer weather and lower therm sales. Normal weather used to set rates for Illinois gas and electric utilities has been based on an average of thirty years of heating degree day and cooling degree day data. Nicor, in this case, proposes to change the Commission's long-standing policy of using thirty years of heating degree data to establish normal weather for purposes of determining the rates charged customers.

Staff witness Beyer recommends that the Commission obtain input from other gas and electric companies on the issue of weather normalization and be well-informed of the broader effects of a decision to abandon the practice of using a thirty-year period to establish weather normalized test year billing determinants. If the Commission accepts the premise of Nicor's proposal, which is that northern Illinois, the Midwest, the United States, and the planet are experiencing a warming trend in all seasons, then, according to Staff, an electric company sharing Nicor's service territory will also be affected by warmer weather. Mr. Beyer states that, if the Commission accepts Nicor's argument that a weather normalization adjustment should be based upon data for the most recent ten-year period to reflect a recent climatic change toward warmer weather and follows that decision in the next rate case for an electric utility (e.g., ComEd), the result will be to drive downward the rate per kilowatt hour for that electric company's new rates. (Staff Ex. 18.0, at 4.) Staff also opines that Nicor witness Takle's attempt to limit his testimony to Nicor's service territory and the winter heating season diminishes his credibility and suggests that the record in this proceeding is not adequate to make the sweeping changes proposed by Nicor.

Staff argues that the Company's proposal to abandon the thirty-year normal weather period is based partly on historical degree days, and partly on judgment—the Company's choice of ten-year data instead of some other period. Company witness Takle, referring to the report by Easterling et al. (Easterling, William E., James R. Angel, and Scott A. Kirsch, "The Appropriate Use of Climatic Information in Illinois Natural Gas Utility Weather Normalization Techniques." (Ill. State Water Survey, 1990)), testified that a period of time between 6 and 20 years is recommended. Staff further asserts that the Company provided no evidence that the proposed period of ten years is superior to some other period within that range, such as 8 or 12 years. Staff concludes that the absence of a Company response on this point supports its contention that, if allowed, utilities will seek weather normalization periods to maximize revenues.

Mr. Beyer proposes that the Commission can explore the issue of how to best determine normal weather in a proceeding that would allow Illinois' gas and electric utilities to articulate their positions on the issue. By using that approach, the Commission could gather comprehensive evidence on differences and similarities of weather impacts upon utilities' service territories. Mr. Beyer also suggests that 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.

Finally, Staff notes that the trier of fact "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).) Furthermore, Staff states that a court may reject 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).) Staff therefore concludes that the lack of a point-by-point debate regarding the testimonies of Messrs. Takle and Herrera does not obligate the Commission to adopt Nicor's ten-year weather normalization proposal.

Determining the best approach to normal weather is a complex task based on objective and subjective elements. According to Staff, the Commission has used a single standard for many years and has applied that standard to determine normal weather for all natural gas and electric utilities where usage is affected by weather. Staff states that deviating from the existing model should not occur on a case-by-case basis, but only after consideration of the effects upon Illinois natural gas and electric utilities and other parties. Changing weather normalization methods from case to case, Staff asserts, likely will result in customers being subject to different weather normalization methodologies by their gas and electric utilities. Such inconsistency is unfair to ratepayers.

Commission Analysis and Conclusion

At issue is whether Nicor's proposal for a ten-year weather normalization period is allowed under the Part 285 Rules, and if so, whether it should be adopted. As the Commission noted in determining the methodology for measuring rate base, the Part 285 Rules were revised in Docket 02-0509, and took effect on August 1, 2003. During that rulemaking, the following language was adopted concerning weather normalization:

> (Electric and Gas Utilities Only) Provide quantitative weather normalization data consistent with utility's service area. Include a full explanation of the normalization method selected and explain why it is appropriate. Provide the number of monthly heating degree days and/or cooling degree days assumed. Identify and explain each of the key assumptions in the methodology. Also, if an historic test year is used, provide the number of monthly heating degree days and/or cooling degree days actually experienced by the utility in the test year and state the source of that data (i.e., location of weather station). Provide the 30 year monthly and annual averages using the heating degree day data and/or cooling degree day data from the same weather station previously mentioned.

(83 Ill. Adm. Code § 285.5025(a)(2).)

Two interpretations of this language are plausible. One possibility is that the last two sentences apply only to rate cases with a historical test year. This reading extends the condition (election of a historical test year) to the requirement for providing thirty years of data. The other possibility is that the historical test year condition applies only to the sentence containing it, even though that sentence is located in the middle of a series of generally applicable requirements.

Under the first interpretation, utilities only would be required to provide thirty years of heating or cooling degree data if they elected a historic test year. This would, in essence, allow utilities the option to elect any weather normalization period and withhold the relevant data to determine whether or not the choice is appropriate. Such an outcome is not consistent with Section 9-201 of the Public Utilities Act, which places the burden of proof on the utility to establish that the rates are just and reasonable. The Commission therefore rejects the first interpretation. Utilities therefore must provide thirty year monthly and annual averages of heating or cooling degree days regardless of whether a historical or future test year is used. Consistent with the requirement that utilities provide "a full explanation of the normalization method selected and explain [sic] why it is appropriate," however, utilities may provide the thirty years of data but suggest a normalization period other than thirty years. In light of all of this, the Commission finds that it is permissible for Nicor to provide thirty years of heating degree day data, but seek a normalization period of ten years.

The second question is whether the ten-year weather normalization period sought by Nicor should be adopted. Staff argues that the "practice" of a thirty-year normalization period should be followed. Staff, however, does not cite any Administrative Code rule, nor any prior Commission Order, decision, or resolution, to substantiate the alleged practice. The Commission therefore does not find this argument to be persuasive. None of the parties, including Staff, have contested that the ten-year period is not appropriate. No analysis of HDD data has been provided to indicate that the ten-year period proposed by Nicor should not be used. Accordingly, the ten-year weather normalization period is approved.

V. RATE OF RETURN

Overview

Nicor Gas submitted testimony via three witnesses on rate of return and cost of capital. Dr. Jeff Makholm addressed the company's cost of equity while Messrs. Hawley and Mudra addressed Nicor's proposed capital structure and overall weighted average cost of capital ("WACC"). Staff witness Michael McNally addressed Nicor's cost of equity, capital structure and WACC. CUB/CCSAO, through its witness Christopher Thomas, also addressed Nicor's cost of equity, capital structure and WACC. No other party presented testimony or arguments related to cost of capital or rate of return.

All parties agree to the use of a year-end capital structure; the embedded cost of Nicor's long-term debt is (6.72%); and, the embedded cost of Nicor's non-redeemable preferred stock is (4.77%). The major contested issues are the inclusion of short-term debt in the capital structure; the cost of the short-term debt in the event it was included;

adjustments to capital structure component balances; cost of common equity; and, Nicor's flotation cost adjustment.

Nicor estimates its cost of common equity is 10.82%, which corresponds to a 9.03% weighted cost of capital. Staff estimates that Nicor's overall cost of capital is 7.55%, which incorporates Staff's proposed 9.54% cost of common equity. CUB/CCSAO/AG estimates that Nicor's overall cost of capital is 7.69%, which incorporates CUB/CCSAO's proposed 9.86% cost of common equity.

Status of Short-Term Debt in Nicor's Capital Structure

Nicor

Nicor's proposed capital structure in this proceeding does not include short-term debt. Nicor's argument for the exclusion of short-term debt rests on the premise that it does not use any of the short-term debt as a permanent source of capital for long-term assets. Nicor defines short-term debt as "temporary, seasonal, short-term commercial paper borrowings. Nicor simply views the use of short-term debt as a tool for manage cash requirements and meeting seasonal cash flow needs.

In support of its argument that use of short-term debt is for seasonable cash flow management purposes only, Nicor has introduced evidence into the record that, among other things, demonstrates Nicor Gas' history of typically not having short-term debt outstanding year-around, as well as its forecast of being out of short-term debt for several months during the test year. Nicor argues that it has not had any commercial paper outstanding for, on average, 58 days per year over the last six years, and in three of those years, it did not issue any short-term debt for 99 days or more. (Mudra Sur., Nicor Gas Ex. 36.0, 8:172 – 174) Nicor further points out that in 2005 specifically, Nicor Gas reached a zero short-term debt balance on March 10, 2005, is not currently expected to issue short-term debt until the third quarter of 2005, more than four months later, and as of May 13, 2005, had not used any short-term debt for 64 days (and counting). (Mudra Sur., Nicor Gas Ex. 36.0, 8:174 – 9:178).

Nicor takes issue with Staff's claim that Nicor Gas' business, and thus its cash demands, are both seasonal, and Staff's subsequent reasoning that since time lags exist for receipts and payables that make short-term debt balances track gas in storage balances it proves that such debt is used to finance rate base. Nicor responds by explaining that its business is seasonal. Its expenses rise in the summer, as its revenues fall, this is no big surprise. When other sources of cash flow are short, Nicor Gas uses short-term borrowing to meet its temporary, seasonal cash flow requirements. In any given month, Nicor Gas also purchases flowing gas, and pays wages, taxes, IS costs, and contractors bills – put simply, short-term borrowing may be used to meet any temporary daily cash flow requirement as needed. Nicor argues that Staff's flawed analysis proves too little because it ignores this practical use of short-term debt as a cash management tool and instead attempts to trace capital between rate base assets and short-term debt - a link which Nicor Gas' testimony strongly disputes – which leads him to misunderstand and re-define Nicor Gas' long-term permanent capitalization, financing and overall required rate of return.

Nicor further asserts that Nicor's perception among investors should be a factor considered by the Commission. According to Nicor, investors understand that Nicor Gas' rate base investments, including its 13-month average balance of gas in storage, are long-term investments, and are not financed with short-term debt. Investors, argues Nicor, view its use of such debt as an effective means of cash management, not as a permanent part of its capital structure. These distinctions are critical, because investors demand returns based on how Nicor Gas is actually financed over the long term, and establishing a fair rate of return requires the application of Nicor Gas' long-term cost of capital to its long-term investment in rate base. Ignoring these distinctions would substantially impede Nicor Gas' ability to earn such a fair return.

Nicor vehemently opposes Staff's proposal to include 100% of Nicor Gas average short-term borrowings in its capital structure. Nicor asserts that adding short-term debt to Nicor Gas' capital structure would be inappropriate and, thus, urges the Commission to reject such a notion.

According to Nicor, the Commission should, decide the short-term debt issue in accordance with the decision in the '95 Rate Case and not include it in Nicor's capital structure for ratemaking purposes. Nicor argues it would be extraordinary for the Commission to include short-term debt in Nicor Gas' capital structure. Nicor points out that the Commission has already evaluated the exact same debt in the exact same circumstances with the exact same purposes for the exact same utility, and has rightly approved that exclusion. *In re Northern Illinois Gas Co.,* Docket 95-0219, 1996 Ill. PUC Lexis 204 at (Order April 3, 1996).

Nicor also emphasizes Staff's silence regarding the Commission's 2002 decision that set the avoided carrying costs for Nicor Gas' gas in storage. In establishing these costs, the Commission used the long-term cost of capital approved in the 1995 Rate Case, not the cost of short–term debt. *In re Citizens Utility Board et al.*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at *40 (Order on Rehearing Jan. 3, 2002).

Nicor takes issue with Staff' and CUB/CCSAO's attempts to "trace" individual dollars of capital from source to use calling them "not only imprecise and fruitless." Nicor asks the Commission to focus on how Nicor Gas' rate base is financed. According to Nicor, it finances its rate base from a base level of long-term, permanent sources of capital with a stable structure, not with short-term debt. That Nicor Gas uses short-term debt on a temporary basis, for only parts of the year, as almost all businesses do, does not imply that such debt is used for long-term capitalization or rate base. In support, Nicor points to the fact that it is out of short-term debt for substantial portions of the year, that it eliminates its short-term debt balances as soon as its receipts allow (not based on whether it is buying or selling gas or any other asset), and that short-term debt is simply the last source to which Nicor Gas will turn if, and only if, additional cash is needed for temporary or seasonal requirements.

Nicor further points to its actual practices in managing its long-term capital structure. With respect to gas in storage, in particular, the market expects and demands that Nicor Gas earn a long-term return commensurate with its long-term average investment in that asset. Nicor believes such market behavior makes sense, given that seasonally-variable gas in storage balances go hand in hand with Nicor Gas’ very long-term investment in its aquifer storage fields. The notion that Nicor Gas should earn only a short-term return on this asset is thus inconsistent with investor expectations. To further illustrate the point, Nicor points to the accounting treatment of gas in storage. According to Nicor, this asset is accounted for on a LIFO layer basis, and therefore reflects gas that was stored from one to many years ago. Treating this asset as a purely short-term asset would not be consistent with such accounting.

Nicor refutes Staff’s claim that Nicor Gas’ gas in storage could be related to short-term debt. According to Nicor, the Commission, in setting the avoided carrying costs of this asset in 2002, determined that such costs were based on the long-term cost of capital approved in the 1995 Rate Case, not on the cost of short–term debt. *In re Citizens Utility Board et al.*, Docket 00-0620 Cons., 2002 Ill. PUC Lexis 16 at *40 (Order on Rehearing Jan. 3, 2002). In fact, Staff argued in that case that storage gas was not financed by short-term debt. (*Id*. at *35.) Nicor states that Staff witness McNally does not and cannot reconcile that position – or the Commission’s ruling, setting the carrying charge based on the 1995 cost of capital that expressly excludes short-term debt – with his position in this case. Nor can Mr. McNally reconcile his position here with Staff’s support of the exclusion of short-term debt from Nicor Gas’ capital structure in the 1995 Rate Case. Nicor claims that Staff’s 180-degree turnaround on this issue is neither explicable nor justified. In these circumstances, where the Commission has determined the general issue of excluding Nicor Gas’ short-term debt from its capital structure, as well as the specific issue of treating Nicor Gas’ gas in storage as not being supported by such debt – and Staff has heretofore supported those determinations – there is simply no reason for the Commission to revisit such issues again in this proceeding

Nicor argues that the Commission should also reject Staff’s suggestion that Part 285 of Title 83 somehow mandates that the short term debt be included in this proceeding. According to Nicor, Staff’s claim is legally erroneous. Nicor views Part 285 as solely setting out requirements for information that the utility must provide at the time of filing; it does not establish substantive law or rules of decision. 83 Ill. Admin. Code Part 285. Part 285 of Title 83 sets out requirements for information that a utility must provide at the time of filing. It does not establish substantive law of rates, or rules of decision. Part 285’s exclusive role of establishing “standard information requirements” is plainly stated in Part 285 itself: “These standard information requirements are designed to assist the Staff of the Illinois Commerce Commission (Commission, ICC, or ILCC) to review filings for tariffed rate increases under Sections 9-201 and 16-108 of the Public Utilities Act (Act) [220 ILCS 5/9 -201 and 16-108].” 83 Ill. Admin. Code § 285.110(a). Part 285 makes clear that it does “not bind the Commission to a decision based solely on data provided pursuant to this Part ….” and confirms that “parties and Commission Staff may seek additional information through discovery.” 83 Ill. Admin. Code § 285.110(b). Nicor does not find a legal basis for witness McNally’s assertion that Part 285 requires inclusion of short-term debt in capital structure absent a certain showing. Nicor further points to Staff’s own inconsistency on this account by highlighting an exchange during the evidentiary hearing where Staff witness Thomas Griffin testified that Part 285 establishes filing requirements and does not preclude parties from using different or additional data or adjustments for ratemaking purposes. (Griffin, Tr. 1097:22 – 1098:20)

Nicor also presents some policy reasons as to why the Commission should not include short-term debt in its capital structure. Nicor contends that improper inclusion of short-term debt in Nicor Gas' capital structure would have several other harmful effects. For instance, short-term interest risk and variability would be unfairly introduced into Nicor Gas' rate of return, and Nicor Gas' ability to attract adequate levels of capital in the future would be impeded. Including short-term debt also would send irrational economic and financial signals to other utilities that do not actually rely on such debt as a source of long-term financing, and would encourage them to hold excess long-term debt or common equity, which in turn would drive up the cost of capital and thereby increase those firms' financial risk and reduce their financial flexibility.

Nicor continues to argue that including short-term debt would also have a radical and unfair impact because Staff's proposal to include $177.6 million of commercial paper at 2.58% would reduce Nicor Gas' revenue requirement by $18.9 million (assuming Nicor Gas' proposed rate base) when, again, there has been no change in the use of commercial paper as a temporary cash management tool.

Nicor also urges the Commission to consider the more general implications of forcing short-term debt into Nicor Gas' capital structure. Nicor asserts that if the Commission holds that Nicor Gas' capital structure must include short-term debt because of cash fungibility, despite the evidence that Nicor Gas uses such debt solely for cash management purposes, then it should expect that every utility using any short-term debt balance, for whatever purpose, will be put in the same position. Nicor points to this as simply another reason why including short-term debt in the capital structure is unfair since Nicor has been consistent in excluding short-term debt, regardless of whether such exclusion hurts it (as it did in 1987) or helps it (as it does in this case). Staff, argues Nicor, has been inconsistent, apparently choosing a "results-oriented approach" aimed at lowering Nicor Gas' rate of return despite the fact that there has been no change in the nature or uses of Nicor Gas' short-term debt since Staff supported a capital structure that did not include such debt in 1987.

Nicor also urges the Commission to reject CUB/CCSAO's "results-driven arguments" regarding the inclusion of short-term debt in the capital structure. Nicor asserts that CUB/CCSAO's argument that Nicor's capital structure is "equity heavy," and that setting rates based on Nicor Gas' proposed balance will increase the rate of return without providing any benefit to ratepayers, is not based on any well-reasoned analysis. Nicor finds CUB/CCSAO's suggestion that Nicor Gas' capital structure should be determined by Standard & Poor's ("S&P's") guidelines equally inappropriate. Nicor responds that the record clearly shows that the single S&P guideline on which CUB/CCSAO exclusively relies is not an appropriate tool to fabricate new, artificial capital structures, a fact that S&P itself confirmed, noting, among other things, that this guideline is only one of several measures that S&P uses. Nicor believes that Staff too makes flawed use of S&P, asserting that S&P has concluded that Nicor Gas uses short-term debt to purchase gas in storage. This assertion, however, badly mischaracterizes the S&P

report on which Staff relies considering that the same S&P report repeatedly refers to the seasonal nature of Nicor Gas' business, and notes that "[c]ash requirements typically increase of the third and fourth quarters…." Nicor, therefore, concludes that the S&P recognizes Nicor Gas' use of short-term debt as a cash management tool, not as a source of capital funding.

CUB/CCSAO suggests that Staff's proposed inclusion of $177.6 million of commercial paper at 2.58% be used. Nicor asks the Commission to reject this proposal not only because short-term debt does not belong in Nicor Gas' capital structure in the first place, but also because such an amount would have a radical and unfair impact. As Nicor Gas explained, its revenue requirement would be reduced by $18.9 million (assuming its proposed rate base) when, again, there has been no change in the use of commercial paper as a temporary cash management tool. Moreover, the 2.58% cost is demonstrably not Nicor Gas' actual cost of short-term debt; it is at best a flawed measure of interest costs only. In addition, it is a flawed measure at that, as illustrated by derivation from a spot measurement from a single source, ignores the time-weighted approach based on Nicor Gas' actual forecast balances outlined on Schedule D-2 (Revised and Updated) Exhibit 20.4 and by the fact that is it significantly lower than even the 3.00% Federal Funds Target Rate at the time of the hearing. In these circumstances, the Commission can and should easily follow its repeated rulings excluding short-term debt from Nicor Gas' capital structure, and thus should accept the capital structure that Nicor Gas is proposing.

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

Staff

Staff witness Mr. McNally proposes to include 100% of Nicor Gas average short-term borrowings in its capital structure. (*See, e.g.*, McNally Dir., Staff Ex. 5.0, Sch. 5.2). Mr. McNally stated that, due to the fungibility of capital, one cannot identify which capital source funds which assets. Since Nicor Gas consistently relies on short-term debt as a source of funds, short-term debt should be included in Nicor Gas' capital structure unless it is shown that short-term debt does not support rate base, as described in Commission rule 83 Ill. Adm. Code § 285.4010(a). Nicor Gas, which carries the burden of proof in this regard, failed to make that showing.

According to Staff, the Company forecast that it will use short-term debt during nine of the twelve months of 2005 and has a long history of relying on short-term debt to finance its operations. Thus, short-term debt is an important source of capital for the Company.

Staff argues that Nicor Gas' rate base is not exclusively composed of long-term assets and its balance indisputably varies. For example, working gas, which is included in Nicor Gas' rate base, is not categorized as a long-term asset, but rather, as a current (i.e., short-term) asset. In addition, Staff points out that the Company employs 13-month averages for the balances of rate base components "materials and supplies" and "gas in storage" specifically because of the relatively high degree of variability of their balances. Indeed, the monthly gas in storage balance alone will vary by over $331 million throughout the test year. In contrast, balances of Nicor's long-term capital sources (i.e., long-term debt, preferred stock, and common equity) vary so little over the test year that Nicor Gas deemed that a single measurement date, December 31, 2005, was sufficient to measure them accurately. Given the static nature of the balances of Nicor Gas' long-term capital sources, the highly variable gas in storage balance must have a similarly variable source of funding. Short-term debt is that variable source.

Since Nicor Gas includes assets with balances that vary greatly throughout the test year in its rate base, there must be a variable source of capital to support those assets. Nicor Gas does have a variable source of capital in short-term debt, which very closely tracks the variability in the Company's single most variable rate base asset, gas in storage. Even Standard and Poor's ("S&P") concluded that Nicor Gas uses short-term debt to purchase gas in storage.

In attempting to discredit Nicor's argument that short-term debt must not be financing rate base because Nicor Gas forecasts zero short-term debt balances for three months during the test year, Staff points out that some of Nicor Gas' rate base components display indisputable, significant variation. Staff reasons that "permanency," in the sense of continual, positive balances, is not a prerequisite for including short-term debt in the capital structure. The Commission made that abundantly clear in Docket No. 95-0076 by including short-term debt in Illinois American Water Company's ("IAWC") capital structure despite the fact that IAWC projected zero short-term debt balances for three months of the test year, just as Nicor Gas has in the instant docket. (Order, Docket No. 95-0076, December 20, 1995, pp. 49 and 51).

Staff also refutes Nicor's 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. Staff sets forth several arguments in support of its position.

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. 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. 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 is constant over time. As explained in Staff's Initial Brief, such a notion is erroneous.

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 argues that the Company has no "rate base investors," because investors purchase a company's securities, not its assets. Rather, Staff argues, Nicor has short-term debt investors, long-term debt investors, preferred stock investors, and one common stock investor, Nicor, Inc. Clearly, investors in Nicor Gas' short-term debt do not seek long-term returns on that investment. Thus, a short-term return matches the return requirements of Nicor Gas' short-term investors. Even, assuming *arguendo*, that a "rate base investor" exists, the statement that short-term debt does not match the alleged long-term return requirements of those "rate base investors" would be true only if one begins with the conclusion that short-term debt does not support rate base.

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 Init. Br., at 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.

Nor does Staff accept the notion 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. 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.

Staff also disagrees with the Company's claims that its LIFO accounting supports its conclusion that the assets in rate base should all be treated as long-term assets. 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 are 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.

Further, 83 Ill. Adm. Code § 285.4010(a) indicates that short-term debt is a part of a utility's capital structure unless short-term debt can be shown to financing exclusively assets excluded from rate base.

Staff argues that the Commission must revisit its exclusion of Nicor's short-term debt from its capital structure in the Company's last rate case (Docket No. 95-0219) because a subsequent rule revision to part 285 mandates a different result in this proceeding. According to Staff, short-term debt is currently required to be included in the capital structure with certain exceptions under Part 285.

Specifically, Staff points to the revision of 83 Ill. Adm. Code Section 285.4010. Staff points to the rulemaking history of this particular provision to augment its position. According to Staff, 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. 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).)

Staff also rejects Nicor's contention that Staff witness Griffin's testimony regarding Part 285 conflict's with Staff's interpretation of 285.4010(a). Staff points out that 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 *unless the utility demonstrates otherwise.* 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.

Staff disagrees with Nicor's contention that simply because short-term debt was excluded from Nicor Gas' capital structure in its previous rate cases, Docket Nos. 87-0032 and 95-0219, the Commission should likewise exclude short-term debt from Nicor Gas' capital structure in the instant docket. Staff does not believe its position is inconsistent with past rate cases. Staff explains that the Commission's treatment of short-term debt changed over the intervening nine years. Since that time, the Commission revised its rules to state 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." (83 Ill. Adm. Code Part 285 4010(a) (effective August 1, 2003)). Staff argues that the rule revision clearly places the presumption that short-term debt shall be included in a utility's capital structure. In contrast, Docket Nos. 87-0032 and 95-0219 were decided under the former standard, in which short-term debt was presumed not to be supporting rate base unless shown otherwise.

Of the two previous Nicor Gas rate case, Docket Nos. 87-0032 and 95-0219, the former states the old short-term debt standard more clearly: The Commission is further of the opinion that short-term debt should not be included in Respondent's capital structure for the purpose of setting rates herein. The cost of short-term debt is volatile and should only be included in capital structure when it is clear that it is a permanent component of a utility's rate base. (Order, Docket No. 87-0032, January 20, 1988, p. 26)

In contrast, the Commission Order in Docket No. 95-0219 states only: The Commission finds that the capital structure as recommended by the Staff, and concurred in by the Company, is reasonable and appropriate. We do not find Mr. Selecky's argument regarding short-term debt to be convincing or consistent with prior Commission decisions and we, therefore, reject his argument on that issue. (Order, Docket No. 95-0219, April 3, 1996, p. 38) that is unjust and unreasonable. (Nicor Gas Exhibit 20B.0, p. 2)

Moreover, Staff argues there are at least two prior rate cases analogous to this one as far as the short-term debt issue goes. Staff states these cases stand for the proposition that a positive continual balance of short-term debt is not a prerequisite for including short-term debt in the capital structure. 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). 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)

Staff also refutes Nicor's characterization of the inclusion of cost of short-term debt in a company's capital structure as a "penalty" for the use of short-term debt. Staff emphasizes that MidAmerican Energy Company ("MEC") made the same argument in Docket No. 99-0534, and the Commission rejected it.

Staff also takes issue with Nicor's assertion that Staff proposes the inclusion of short-term debt "simply to lower returns." Staff insists that it proposes including short-term debt in the capital structure in order to accurately measure the cost of capital to apply to rate base. Mr. Mudra's argument that the inclusion of short-term debt would understate the investor required return assumes the conclusion that short-term debt does not support rate base. (Nicor Gas Exhibit 20B.0, pp. 23-24) As Staff has shown, the Company has not met its burden on that issue. Furthermore, if the Company truly felt it would not be in its best interest to continue to use short-term debt, its forecasts, presumably, would not reflect a continued use of short-term debt, since such use of short-term debt is entirely at the Company's discretion. However, given that the

Company continues to utilize short-term debt, its rates should include the cost of that capital.

Staff does not agree that the inclusion of short-term debt would unfairly introduce short-term interest rate risk into Nicor Gas' rate of return. Nor does Staff believe the Commission's inclusion of such debt into the capital structure would encourage other firms to abandon use of short-term debt in favor of long-term capital instruments. Staff points out that 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. Staff further argues that not only does the inclusion of short-term debt not penalize the Company, but rather only serves to accurately reflect the capital costs incurred by the Company. Staff surmises if the Company truly believed that the use of short-term debt is too risky, it would not have forecast a continued use of short-term debt.

Finally, Staff takes issue with Nicor's alternative argument that is the Commission was to conclude that Nicor Gas' short-term debt should be included in its capital structure; the balance should only be $36,625,000. Staff sees no reason for the Commission to reduce Staff's proposed amount. 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. A comprehensive matching of capital to uses, which would be necessary if one were to try to match any capital, is an impossibility.

In summary, if short-term debt were excluded from the Company's capital structure, Nicor Gas' customers would compensate the Company for a higher rate of return on capital than the Company is paying to its investors. This would unjustly enrich Nicor Gas' investors at the expense of its customers. Therefore, as a matter of regulatory fairness, the Commission should include short-term debt in the capital structure for the purpose of establishing rates.

CUB/CCSAO

Like Staff, CUB/CCSAO argues for the inclusion of Nicor's short-term debt into the capital structure for ratemaking purposes. CUB/CCSAO asserts that Nicor Gas uses short-term debt to finance a portion of its rate base, and that short-term debt is included in Nicor Gas' actual capital structure. CUB/CCSAO, therefore, supports a short-term debt balance of $177,608,000

CUB/CCSAO argues that Nicor has not met its burden in this instance and therefore the Commission must consider Nicor's use of short-term debt in setting rates. It is not uncommon for short-term debt to be included in a utility's capital structure for ratemaking purposes. *See, e.g.*, Fl. Pub. Svc. Comm'n Feb. 9, 2004 Order Docket No. 030569-GU, Order No. PSC-04-0128-PAA-GU; Ky. Pub. Svc. Comm'n Nov. 10, 2004

Order, Case No. 2004-00067; Wash. Util. & Transp. Comm'n Feb. 18, 2005 Order, Docket No. UE-040641; Wisc. Pub. Svc. Comm'n Dec. 21, 2004 Order, 6690-UR-116 (Including short-term debt for ratemaking purposes without extensive analysis). CUB asserts that this Commission's policy on including short-term debt is consistent with the policies in other states. For example, the Indiana Regulatory Commission excluded short-term debt in one case only when the utility proved that the short-term debt was not used to finance rate base. Order, Cause No. 42359, Ind. Regulatory Comm'n May 18, 2004.

CUB/CCSAO joins Staff in its claim that Nicor failed to meet its burden under Section 285-4010(a) of the Administrative Code to show that short-term debt is entirely financing assets that are not included in the utility's rate base. According to CUB/CCSAO, Nicor's argument that it does not use any short-term debt to provide a permanent source of capital for long-term assets is premised on the mistaken idea that Nicor Gas' rate base balance is constant over time. Nicor Gas' rate base is not exclusively composed of long-term assets and its balance indisputably varies. For example, working gas, which is included in Nicor Gas' rate base, is not categorized as a long-term asset, but rather, as a current (i.e., short-term) asset.

CUB/CCSAO fully agrees with Staff that short-term debt should be included in Nicor's capital structure for ratemaking purposes. CUB/CCSAO asserts that Nicor's proposed capital structure fails to recognize the Company's use of short term debt. CUB/CCSAO disagrees with Nicor's assertions that short term debt is solely used as a capital management tool to manage seasonal cash flow needs. CUB/CCSAO argues that capital is fungible, meaning that any one dollar of capital cannot be said to finance any individual project. Rather, all investment is financed in proportion to a company's total capitalization. CUB/CCSAO point out that Nicor itself acknowledged that the specific uses of its cash "can not be strictly defined."

CUB/CCSAO further argues that failure to recognize Nicor's use of short term debt will result in unreasonable rates. Although CUB/CCSAO witness Thomas acknowledges that Nicor's use of short-term debt in its operations is a prudent decision by management to lower costs and has allowed Nicor to operate efficiently for years, he still points out that Nicor's proposed capital structure does not recognize the benefit of short-term debt and "fails to cover approximately 20.74% of its proposed rate base, contrary to the Company's claim that its proposed capital structure is Nicor's actual capital structure." The Commission has previously found that a utility need not reconcile its rate base with its capital structure, however the large discrepancy between Nicor's requested capital structure and requested rate base certainly merits further investigation. CUB/CCSAO asserts that the record clearly demonstrates that the failure to include short-term debt in Nicor capital structure for ratemaking purposes results in an unreasonable capital structure. Both Mr. McNally and Mr. Thomas used the S&P corporate criteria guidelines to evaluate the reasonableness of Nicor's capital structure, and the only capital structure that falls within these guidelines is the capital structure that includes short-term debt. If the Commission fails to incorporate short-term debt, it will allow Nicor to earn a higher rate of return than the actual cost that Nicor incurs in financing its rate base. This is unreasonable and unnecessary.

CUB/CCSAO, like Staff, rejects Nicor's assertion that including short-term debt would send irrational economic and financial signals to other utilities that do not actually rely on such debt encouraging them to hold excess long-term debt or common equity, which in turn would drive up the cost of capital and thereby increase those firms' financial risk and reduce their financial flexibility. CUB/CCSAO states that this argument is irrelevant and premised on Nicor's flawed argument that by including short-term debt the Commission is somehow denying Nicor's investors an adequate return on their investment and will make them more reluctant to invest in Nicor in the future. CUB/CCSAO believes it has sufficiently demonstrated that this is inaccurate and that including short-term debt results in a capital structure within the range of what S&P expects for similarly situated utilities. Furthermore, this is consistent with the fact that other State Commissions include short-term debt for ratemaking purposes.

CUB/CCSAO contends it has presented persuasive evidence to demonstrate that without short-term debt, Nicor's proposed capital structure "is unnecessarily equity heavy," and "will result in an increased rate of return for the company that will provide no benefit for regulated ratepayers." Furthermore, Nicor has only made unsupported broad statements about impaired capital attraction and has not presented any credible evidence on how the financial community will react to a Commission order in this proceeding. The Commission should not be dissuaded from including the short-term debt, which Nicor actually uses to finance rate base assets, in Nicor's ratemaking capital structure.

CUB/CCSAO also urges the Commission to reject Nicor's alternative argument in the event that the Commission decides to include short-term debt it should include no more than the maximum amount that could have funded the purchase of gas in storage. Both Staff and CUB/CCSAO have demonstrated that capital is fungible, and that all investment is financed in proportion to a company's total capitalization. Entities, such as Nicor, whose expenses vary greatly throughout the year, cannot prescribe specific uses for individual sources of capital. Rather, such entities will endeavor to use the capital they have available at any given time to meet their obligations and then use available financial instruments, like short-term debt, to meet any remaining obligations. Nicor has even acknowledged this fact. There is no basis in fact for the Commission to accept Nicor's flawed proposal, and the Commission should disregard this thinly veiled attempt by Nicor to augment its allowed rate of return at the expense of regulated ratepayers.

In sum, CUB/CCSAO urges the Commission to adopt Staff's proposed inclusion of $177,608,285 in Nicor's capital structure for ratemaking purposes. Nicor has not demonstrated that short-term debt does not support rate-base and therefore cannot demonstrate that only working gas is financed by short-term debt.

Commission Analysis and Conclusion

The core issue being contested in the determination of Nicor's capital structure is whether short-term debt should be included in the Company's capital structure for ratemaking purposes. The Commission concludes that Nicor's short-term debt is properly excluded from its capital structure.

Short-term debt is a loan for which the scheduled repayment and the anticipated use for the money is expected to be a year or less. Working capital lines of credit and short maturity commercial loans are considered short term debt financing. The Commission in the past has treated short-term debt in various ways, depending on the specifics of the record in each case. *MidAmerican Energy Company*, 2000 Ill. PUC Lexis 563, *29-30 (Order, Docket 99-0534, July 11, 2000); *In Re Northern Illinois Gas Co.*, Docket 87-0032, 1988 Ill. PUC Lexis 37 at *11 (Order Jan. 20, 1988); *Illinois American Water Company*, 1995 Ill. PUC Lexis 887, 103-104 (Order, Docket 95-0076, December 20, 1995); *In re Northern Illinois Gas Co.,* Docket 95-0219, 1996 Ill. PUC Lexis 204 at *82 – 83 (Order April 3, 1996). The Commission believes that it is appropriate to exclude short-term debt from a utility's capital structure for ratemaking purposes if the utility clearly establishes by a preponderance of the evidence that it is not using short-term debt to finance rate base items.

In Nicor's most recent rate case in 1995, Staff did not oppose the Company in its request to have its short-term debt excluded from the test year capital structure. In the same way as Staff and CUB/CCSAO do here, in that particular proceeding, the IIEC argued that the Company's short-term debt should be included in the test year capital structure since, according to IIEC this short-term debt appeared to be a major component of NI-Gas' capitalization. The Commission held as follows:

> Both the Company and Staff oppose this proposal and contend that the Company's short-term debt should be excluded because the Company does not use its short-term debt to finance long-term investments, but instead uses it to meet seasonal cash requirements. (NI-Gas Ex. 9 at 3). They note that the Commission typically excludes this type of short-term debt from capital structure. The Commission finds that the capital structure as recommended by the Staff, and concurred in by the Company, is reasonable and appropriate. We do not find Mr. Selecky's argument regarding short-term debt to be convincing or consistent with prior Commission decisions and we, therefore, reject his argument on that issue.

(Docket 95-0219 at 37).

As an initial matter, we need to determine whether there have been any material changes in circumstances since Nicor's last rate case that would lead to the inclusion of short-term debt this time around. One relevant change in law involves the revision of 83 Ill. Adm. Code Part 285 in Docket 02-0509. According to Staff, short-term debt is currently required to be included in the capital structure with certain exceptions under Part 285. Staff attempts to distinguish the Commission's exclusion of Nicor's short-term debt from its capital structure in the Company's last rate case (Docket No. 95-0219) by arguing that the subsequent revision to Part 285 mandates a different result in this proceeding. Staff now argues that the revised rule, which became effective August 1, 2003, places the presumption that short term debt shall be included in a utility's capital structure.

The Code provision at issue states:

> The utility shall provide a summary calculation of the weighted average cost of capital on a total company and jurisdictional basis; however, jurisdictional data is not required if the weights and costs of the components of the capital structure do not differ from total company data. *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.* For all classes shown, the amount, percentage of total, percentage cost, and weighted cost shall be provided. A summary shall be provided for each year from and including the last completed calendar or fiscal year through the capital structure measurement period. If the cost of capital shown on Schedule D-1 is not the same as that shown on Schedule A-2 required by Section 285.1005(a)(4), the utility shall provide an explanation for the difference.

83 Ill. Adm. Code § 285.4010(a) (emphasis added).

Part 285 sets out informational requirements a utility must provide at the time it files its rate case. Section 285.110 clearly sets forth the purpose of Part 285 in its entirety. Section 285.110(a) provides: "These standard information requirements are designed to assist the Staff of the Illinois Commerce Commission (Commission, ICC, or ILCC) to review filings for tariffed rate increases under Sections 9-201 and 16-108 of the Public Utilities Act (Act) [220 ILCS 5/9 -201 and 16-108]." 83 Ill. Adm. Code § 285.110(a). More importantly, Section 285.110(b) clearly states that "These standard information requirements *do not bind the Commission to a decision based solely on data provided pursuant to this Part*, and parties and Commission Staff may seek additional information through discovery." 83 Ill. Admin. Code § 285.110(b)(emphasis added).

Part 285 is better characterized as procedural and administrative in nature, as opposed to a substantive law that binds us when deciding the issue of whether or not short-term debt should be included in Nicor's capital structure. Indeed, Staff's own witness conceded on the record that Part 285 is intended to establish filing requirements and does not preclude parties from using different or additional data or adjustments for ratemaking purposes. (Griffin, Tr. 1097:22 – 1098:20).

Assuming arguendo, that the revised Part 285 was construed as a substantive legal provision that bound the Commission, its language clearly affords the utility the right to demonstrate through the evidentiary record 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." 83 Ill. Adm. Code § 285.4010(a). The key determination on whether short-term debt is included or excluded from the capital structure is the *purpose* of the short-term debt. If the utility sufficiently demonstrates that its short-term debt is not being utilized to finance long-term rate base assets, then the Commission can properly exclude it from the utility's capital structure.

With that in mind, we now turn to the record evidence to determine whether Nicor has sufficiently made that requisite showing. We find that it has. Nicor explained that this debt is not used to provide a source of capital for long term assets. No party has disputed that Nicor's business, natural gas distribution, is seasonal in nature. The Company's expenses rise in the summer, the same time its revenue is at its lowest levels. During this time period, Nicor, like all businesses, has financial obligations it must meet. In order to meet these temporary and short-term cash flow requirements, Nicor turns to its utilization of short-term debt.

Nicor also presented persuasive evidence demonstrating that short-term debt is used intermittently throughout the year. Nicor typically does not carry short-term debt balances year round. Nicor will be out of short-term debt for several months throughout the test year. The record further shows that Nicor Gas has not had any commercial paper outstanding for, on average, 58 days per year over the last six years, and in three of those years, it did not issue any short-term debt for 99 days or more. The record also indicates that in 2005 specifically, Nicor Gas reached a zero short-term debt balance on March 10, 2005, is not currently expected to issue short-term debt until the third quarter of 2005, more than four months later, and as of May 13, 2005, had not used any short-term debt for 64 days. Nicor further distinguished its use of short term debt from capital that finances long-term assets by explaining that short-term debt is the last source of financing for Nicor since it seeks to exhaust all other sources first.

Staff argues that Nicor mischaracterizes its rate base as being comprised solely of "long-term" assets funded with capital that is compensated at long-term rates. Staff points to gas-in-storage, particularly Nicor's "working gas" which is forecast to vary by $331 million during 2005, and reasons that the variable portion of that asset must have a variable source of financing. Staff concludes that the variable source of financing is Nicor's short term debt and that must be included in the Company's capital structure.

Staff's argument that the Commission, in its Order in Docket 95-0076 has previously ruled that "permanency" in the sense of continual, positive balances, is not a prerequisite for including short-term debt in the capital structure is not entirely accurate. While true that the Commission included short-term debt in IAWC's capital structure, that was due to the fact that IAWC indicated it would have short-term debt outstanding most of the year. Moreover, that case is further distinguishable in that the short-term debt in that proceeding was specifically earmarked to support construction activities throughout the year until long-term financing was approved. Illinois American Water Company, 1995 Ill. PUC Lexis 887, 103-104 (Order, Docket 95-0076, December 20, 1995).

In sum, the Commission finds that the preponderance of record evidence shows that Nicor does not use short-term debt to finance rate base assets or make long-term investments in rate base. The Commission is satisfied that Nicor's use of short-term debt, not unlike other utilities, is to meet the seasonal needs of running its gas operations. We began our analysis by establishing the need to determine whether there have been any material changes, whether factual or legal, in circumstances since Nicor's last rate case that would lead to the inclusion of short-term debt this time around. The Commission did not find any. The Commission rejects Staff and CUB/CCSAO's argument that the revised Part 285 warrants a different result. Part 285 places the burden on the utility to demonstrate in its initial rate case filing that its short-term debt is not being used to finance items that are part of the utility's rate base. We find that Nicor has sufficiently met its burden in this instance. Nicor Gas faces the same need today to respond to daily and seasonal cash flow requirements, including gas costs, with revenues and other available sources of funds as it did in 1995. The record also shows that short-term borrowing was used in the same manner today as it was in 1995. As a result, the Commission finds that short-term debt should be excluded from Nicor's capital structure in this proceeding.

Cost of Short-Term Debt

Nicor

Nicor maintains that since it does not believe that short-term debt should be included in its capital structure, there is no need to address the cost of debt issue. Nicor argues, however, that in the event the Commission were to include short-term debt in the capital structure, Staff's proposed 2.58% is inappropriate for several reasons. Instead, Nicor asserts that any such debt must be included at 4.12% which is Nicor Gas' actual cost of test year short-term debt.

As an initial matter, Nicor takes issue with Staff's methodology to calculate the direct interest cost claiming that it was inferior to that used by Nicor Gas due to Staff's use of an annualized daily spot rate, taken on February 7, 2005, as the proxy to set the direct interest cost. Nicor Gas' methodology established 2005-year costs by using as a proxy a broad set of independent forecasts of the Federal Funds Rate, from three independent sources: The Northern Trust Company, Mesirow Financial, and BMO financial.

Further, Nicor Gas argues that Staff's analysis inappropriately excluded the necessary commitment fees supporting short-term-debt. Nicor Gas argues it has presented sufficient evidence into the record which demonstrates that Nicor Gas' commitment fees are necessary and reasonable. This evidence includes: (1) despite Nicor Gas' strong credit profile, the use of credit facilities is required to avoid increased borrowing costs; (2) Nicor Gas has done extensive research to ensure that its commitment fees are reasonable; and (3) year-round commitment fees are reasonable and necessary to guarantee the flexibility and availability of short-term debt required by Nicor Gas. Nicor Gas further argues that it responded to Staff's comment regarding a lack of evidence by highlighting Nicor Gas' Part 285 filings, including the updates thereof, and the testimony establishing the necessity of Nicor Gas' commitment fees and all other identified actual costs of short-term debt.

With respect to Staff's argument in its rebuttal testimony that Nicor Gas had not adequately supported the fee components actual cost of short-term debt, Nicor Gas points to the evidence it submitted in response. Regarding the need for year-round commitment fees, Nicor Gas argued that such fees are the norm and are, in fact, needed due to the unpredictable nature of the need to rely on short-term debt to meet cash flow needs. It argues that the record shows that if bank commitments were not secured, then Nicor Gas' would incur an increase in borrowing costs which would be higher than the savings in commitment fees. Nicor Gas also presented evidence that prior to entering into the credit arrangement, Nicor Gas interviewed a series of banks and received price quotes from several firms. In addition, Nicor Gas stated that the transaction costs associated with returning to the banks routinely to negotiate and secure bank credit rather than relying on longer term commitment arrangements would result in higher costs than any savings in commitment fees. Nicor Gas states that when short-term debt is included in a utility's capital structure, it should be included at the utility's actual cost absent some evidence that cost is unreasonable or imprudent. Nicor Gas points out that Nicor Gas' and Staff's values for the cost of short-term debt differ based on interest rate and commitment fees. Nicor Gas illustrates that they have calculated an interest rate forecast from several different sources while Staff utilized an arbitrarily chosen spot market rate. Nicor points out that Staff's approach did not use the more robust time-weighed rate format for which data is available from Schedule D-2, and appears to have ignored Nicor Gas' actual forecast 2005 short-term debt interest costs, which there is no evidence criticizing as unreasonable or imprudent. In addition, Nicor Gas points out that there is nothing improper about commitment and related fees; they are common in such transactions. In short, Nicor Gas asserts that it has presented sufficient evidence that shows such fees were both necessary and prudent in establishing its actual forecast test-year cost of short-term debt at 4.12%.

Staff

Staff asserts that the cost of short-term debt should reflect the cost of commitment fees related to the Company's short-term debt, if those commitment fees are shown to be reasonably incurred. Staff points out that, until its surrebuttal testimony, the Company did not even explicitly state the purpose for the bank commitments, let alone demonstrate that the bank commitment fees are reasonably incurred. Staff refutes the Company's claim that its surrebuttal testimony addressed the concerns Staff raised.

Staff points out that while Nicor witness Mudra revised the cost of Nicor Gas' bank commitments in his rebuttal testimony to $1.6 million, he failed to indicate (1) the amount of the new bank commitments; (2) the amount of those bank commitments that are assigned to Nicor Inc.; and (3) whether the $1.6 million bank commitment expense reflects a proper 3-year amortization of those costs over the 3-year life of the bank agreement.

Staff reasons that since the bank commitments are shared between Nicor Inc. and Nicor Gas, a proper allocation of the bank commitment fees must be made to satisfy the requirements of 220 ILCS 5/9-230. Pursuant to that section of the Act, not one iota of incremental cost of capital resulting from a utility's affiliation with non-utility companies can be reflected in rates. Staff concludes, therefore, that given the incomplete record on bank commitment fees, the Commission cannot legally add a single basis point to Nicor Gas' cost of capital for those fees.

CUB/CCSAO

CUB/CCSAO adopts Staff's position regarding the cost of short-term debt. According to CUB/CCSAO Nicor Gas has failed to produce sufficient evidence to support the inclusion of commitment fees.

Commission Analysis and Conclusion

As the Commission finds that short-term debt should not be included in the capital structure, there is no further need to address the cost of any such short-term debt

Adjustments to Capital Structure Component Balances

Nicor

Nicor Gas proposed the use, and submitted evidence supporting the use of an end-of-year capital structure for 2005 consisting of: 43.51% long-term debt, 0.12% non-redeemable preferred stock, and 56.37% common equity. Nicor Gas takes issue with Staff's proposed component balance because it does not appear to have used actual year-end book values. According to Nicor Gas, Staff's proposed $18.6 million deduction due to retired debt issues involves debt issues that are not part of the year-end test year capital structure. Nicor Gas also argues that Staff has reduced the actual book balances for long-term debt, common equity and preferred stock by a total of $7.9 million based on the average CWIP balance accruing AFUDC. In short, Nicor Gas argues that this adjustment is unnecessary when there is no short-term debt in the capital structure, as the component ratios will be unchanged by the proportionate adjustment.

Staff

Staff accepts Nicor Gas' proposed end-of-test-year capital structure. There is also no dispute concerning Nicor Gas' embedded cost of long-term debt. Staff, however, does propose an $18.6 million deduction from the actual end-of-test-year book balance of long-term debt. Staff proposes this deduction on the basis that an adjustment is needed to account for certain retired debt. For purposes of consistency, Staff has also reduced the capital structure by $7.9 million based on the average CWIP balance to account for its inclusion of short-term debt in the capital structure.

CUB/CCSAO

CUB/CCSAO argues that Nicor Gas' proposed capital structure is equity-heavy. Similar to Staff, CUB/CCSAO reasons that due to its proposed inclusion of short-term debt, additional adjustments to the capital structure are necessary. While CUB/CCSAO witness Thomas adopted the long-term capital structure proposed by Nicor Gas, CUB/CCSAO argued on brief for the adoption of Staff's proposal, contingent on the inclusion of short-term debt. (CUB/CCSAO Init. Br. at 23.)

Commission Analysis and Conclusion

Staff and Nicor Gas have agreed to use the forecast actual end-of-test-year book balances. As the Commission finds that short-term debt should not be included in the capital structure, there is no further need to address the proposed deduction from the actual end-of-test-year book balance of long-term debt.

Cost of Equity

Nicor

Nicor Gas proposes a rate of return on equity ("ROE") of **10.82%**. (Makholm Reb., Nicor Gas Ex. 21.0, 1:14-19) Nicor asserts that this ROE is fair and reasonable and should be accepted by the Commission. According to Nicor, this rate was based on appropriate and updated inputs, and, similar to Staff's approach, calculated by averaging the results of two widely accepted methods, the discounted cash flow ("DCF") and the capital asset pricing model ("CAPM") methodologies.

Nicor Gas' proposed ROE of 10.82% is the average of the results of the DCF analysis conducted by outside expert, Dr. Jeff Makholm, which estimated a 10.68% ROE, and his CAPM analysis, which estimated a 10.95% ROE. (Makholm Reb., Nicor Gas Ex. 21.0, 1:14 – 19) Nicor argues that its analysis was based on a sound group of comparable companies both when initially chosen and using the latest data available. Nicor's sample group consisted of six publicly-traded companies that face business risks similar to those facing Nicor Gas' utility operations, and that have stock price and dividend payment data that can be readily applied to the DCF model. Companies with similar business risks were defined by witness Makholm as those that derive at least 80 percent of their operating revenues from regulated utility operations (Nicor Inc. derived approximately 88 percent of its revenues from Nicor Gas' utility operations) and operate as a regulated gas distribution utility.

In order to ensure that the proxy group consisted only of companies with reliable data, only those companies that did not have existing financial concerns about future dividends and that were not known to be potentially involved in mergers or acquisitions were selected. These companies were subsequently compared to Nicor. Nicor further points out that this close comparability is critical because Nicor Gas' ROE cannot be measured directly, and thus a proxy that fairly represents the activities and risks of Nicor Gas must be used.

Nicor also takes issue with Staff's proposal regarding the cost of common equity. According to Nicor, the Commission should disregard Staff's proposal because staff witness McNally made several fundamental and numerically critical errors in generating his proposed ROE of 9.54%.

The most critical flaw in Nicor's view is that his group of proxy companies is not, in fact, fairly comparable. Nicor argues that Staff's criteria were too "relaxed." To illustrate, in selecting comparable companies, Staff required that only 70% of their operating revenues be derived from regulated utility operations. Nicor further points out that, even after newer data conclusively demonstrated that fully half of the companies included no longer met even his relaxed criteria. (Makholm Sur., Nicor Gas Ex. 37.0, 2:25 – 28) As a result, Nicor concludes that Staff's proxy group does not accurately reflect Nicor Gas' risks. Nicor, therefore, believes that its proxy group is far superior to staff witness McNally's and points to the fact that even CUB/CCSAO witness Thomas accepted Nicor Gas' group for his own ROE calculation, noting the reasonableness of "Dr. Makholm's selection criteria." (Tr. 1244:21 – 1245:10) Nicor Gas asserts it proposed a closely matched sample while Staff did not.

Next, Nicor condemns Staff's proposed 23-basis point adjustment to compensate for non-comparability between the risk profile of the proxy group and that of Nicor Gas. Nicor attacks Staff's adjustment on two grounds. First, Nicor argues that is a comparable proxy group had been used there would be no need for such an adjustment. Nicor argues that when the risk profile, for example, of Nicor Gas' proxy group is compared to the risk profile of Nicor Gas, there is no significant difference and no adjustment required. In other words, staff witness McNally's proposed adjustment actually underscores just how incomparable his proxy group is. Second, Nicor urges the Commission to reject witness McNally's proposed adjustment because it improperly mixes debt and equity risks. The risk profiles are based on debt yields, which are not connected to rates of return on equity. According to Nicor witness Makholm, "Equity and debt are very different financial securities – the difference between the bond yield of AA and A rated bonds has nothing to do with differences in equity risk of comparing a proxy group to a single firm." (Makholm Reb., Nicor Gas Ex. 21.0, 9:260 – 10:268) Given these fundamental distinctions between equity and debt, Nicor surmises that nothing in either financial theory or practice justifies this adjustment.

Nicor also refutes witness McNally's growth rate for his DCF analysis. To illustrate, Nicor points out that he uses only a single growth rate source, missing probably the most widely used and most highly regarded source used in utility rate cases source – *The Value Line Investment Survey*. Nicor believes that this omission alone drives Mr. McNally's cost of equity down by 54 basis points. In contrast, Dr. Makholm's growth rate is derived from multiple separate, credible, and complementary sources, including *The Value Line Investment Survey* just mentioned. (Makholm Dir., Nicor Gas Ex. 4.0, 27:542 – 30:603). Nicor believes that witness McNally also erred by using a second, subjective growth rate into his DCF analysis, which he does by selecting, by hand, the "next" dividend payment for his proxy group companies before allowing the base growth rate to take over. Nicor believes that Staff's analysis was further flawed by its failure to include Nicor Gas' flotation costs.

In similar fashion, Nicor disagrees with CUB/CCSAO witness Thomas' attempted calculation of Nicor Gas' ROE, which produced a result of 10.09%. While acknowledging his use of Nicor's proxy group, Nicor, nevertheless, criticizes witness Thomas' adoption of Staff's unwarranted 23-basis point adjustment as proposed by Mr. McNally. In addition, Mr. Thomas, like Mr. McNally, also erroneously fails to include flotation costs.

In sum, Nicor Gas proposes a return on equity calculated in accordance with accepted methodologies, using the most recent data in the record, and without reliance on subjective adjustments. Unlike the estimates proposed by Staff and CUB/CCSAO that would push Nicor Gas' ROE well below its peers (and in Staff's case, below the result any other recent gas case in the nation), it is a fair and just ROE that will permit Nicor Gas to attract the required capital at reasonable cost. Nicor, therefore, urges the Commission to adopt its proposed ROE (10.82%), and reject those proposed by Messrs. McNally and Thomas.

Staff

Staff, through its witness Michael McNally, proposes a rate of return on equity of **9.54%**. Staff estimated the cost of common equity for Nicor Gas with DCF and risk premium models. Staff witness McNally applied those models to a sample of natural gas utility companies. Staff's proxy sample comprised eight cash dividend paying, domestic, publicly-traded companies. The companies were assigned an industry number of 4924 (i.e., natural gas distribution companies) within S&P's *Utility Compustat* database for which Zacks growth forecasts were available. Further selection criteria utilized by Staff for inclusion in the gas sample included finding companies that were not involved in any large, pending merger; and that derive 70% or more of their revenues from regulated gas delivery operations based on 2003 data. (ICC Staff Exhibit 5.0, p. 14).

Staff witness McNally applied a constant-growth quarterly DCF model because the companies in Staff's gas sample pay dividends quarterly. (ICC Staff Exhibit 5.0, pp. 15-16). Mr. McNally measured the market-consensus expected growth rates with projections published by Zacks. The growth rate estimates were combined with the closing stock prices and dividend data as of February 7, 2005. Based on this growth, stock price, and dividend data, Mr. McNally's DCF estimates of the cost of common equity was 9.14% for the Staff gas sample.

Mr. McNally also used a one-factor risk premium model, the CAPM, to estimate the cost of common equity. Staff explained that the CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Mr. McNally combined betas from Value Line and a regression analysis. The average Value Line beta estimate was 0.76, while the regression beta estimate was 0.56. For the risk-free rate parameter, Mr. McNally considered the 2.28% yield on four-week U.S. Treasury bills and the 4.54% yield on twenty-year U.S. Treasury bonds. Both estimates were measured as of February 7, 2005. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 5.6% and 6.0%. Thus, Mr. McNally concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. Finally, for the expected rate of return on the market parameter, Mr. McNally conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 13.40%. Inputting those three parameters into the CAPM, Mr. McNally calculated a cost of common equity estimate of 10.39% for the Gas Sample.

Based on his DCF and risk premium models, Mr. McNally estimated that the cost of common equity for the Gas Sample is 9.77%. To determine the suitability of that cost of equity estimate for Nicor Gas, Mr. McNally compared the average S&P corporate credit ratings and business profiles of his Gas Sample to those of Nicor Gas to assess their relative risk levels. The S&P credit rating and S&P business profile score for the Gas Sample average approximately A and 2.75, respectively. In comparison, S&P assigns Nicor Gas a corporate credit rating of AA and a business profile score of 2. The Gas Sample's lower average corporate credit rating and higher average business profile score indicate that the Gas Sample is significantly riskier than Nicor Gas in terms of overall financial strength. Thus, Mr. McNally concluded that a 23 basis point downward adjustment (reflecting the spread between A-rated and AA-rated 30 year utility debt yields) to the Gas Sample's investor-required rate of return is necessary to estimate the investor-required rate of return for Nicor Gas.

Mr. McNally testified that a thorough cost of common equity analysis requires both the application of financial models and the analyst's informed judgment. Thus, Mr. McNally analyzed the distribution of the individual DCF estimates relative to the observable 5.31% yield on A-rated long-term utility bonds. Mr. McNally concluded that the required rate of return on common equity for Nicor Gas equals 9.54%. Mr. McNally did not include an adjustment for common equity flotation costs since the Company failed to prove that it had any unrecovered common equity flotation costs.

After a thorough description of Mr. McNally's analytical approach, Staff responded to criticisms levied by the company regarding inputs used in Staff's cost of common equity recommendation, including Staff's Gas Sample, growth rate, CAPM, and relative risk adjustment. Staff believes the company's claim that staff's cost of equity recommendation is too low is totally without merit. Additionally, aside from its own independent analysis regarding cost of common equity, Staff reviewed Nicor witness Makholm's equity analysis. According to Staff, several errors exist in Dr. Makholm's analysis that cast doubt on its accuracy and reliability. Staff argues that critical errors were discovered in the following areas: (1) internal inconsistencies in the analysis; (2) the growth rates Dr. Makholm applied in his DCF model; (3) his failure to adjust his cost of equity estimate to reflect the lower risk of Nicor Gas relative to his proxy sample; and, (4) his improper application of a flotation cost adjustment. Staff addresses each area in turn.

As an initial matter, Staff points out several inconsistencies exist in witness Makholm's cost of equity analysis. First, despite using Yahoo! Finance growth rates in his CAPM analysis and arguing that "a credible analysis should use all of the credible sources available," Dr. Makholm excluded from his final growth rate estimate the Yahoo! Finance growth rate estimates for the companies in his sample. Second, he extolled the virtues of Value Line and criticized Staff for not employing Value Line as a source for growth rates, while simultaneously criticizing Value Line's normalization technique and disregarding the growth rates Value Line publishes in favor of his own, contrived growth rates. Third, he improperly combined the higher return on *average* equity, RAV, with the higher *end-of year* book value, Ve, to calculate his sustainable growth rate estimates, which he inconsistently input into a DCF model that incorporates dividend expectations for an yet a different time period. Fourth, although Dr. Makholm concluded that Zacks is a reputable firm and uses Zacks growth rates, he dismissed Zacks published beta estimates. Fifth, although Dr. Makholm criticized the use of the CAPM in utility rate setting, the Company included the results of Dr. Makholm's CAPM in its final cost of equity recommendation. Finally, although Nicor Gas is one of the most financially sound gas distribution utilities in the nation, the Company's cost of equity recommendation actually exceeds the average allowed cost of equity for a miscellaneous group of utilities presented by Dr. Makholm that, on average, is undoubtedly higher in risk. Paradoxically, the inconsistencies above are consistent in one respect: in each case, the Company chose to disregard evidence that would have yielded a lower estimate of the cost of common equity.

Staff refutes Nicor's objections to Staff's gas sample proxy group and maintains that its elected 70% revenue threshold for its sample group is valid. Staff explains that the purpose of using a criterion based on percentage of revenue from gas distribution operations is to produce a sample of companies whose predominant line of business is gas distribution. Staff insists that its sample does so. Staff also takes issue with Nicor's argument that substituting KeySpan and Southwest Gas for AGL Resources, Laclede Group, Peoples Energy, and South Jersey Industries would create a sample that better reflects the risk of Nicor Gas. Staff points out Dr. Makholm found that the DCF cost of equity estimate resulting from that substitution would be higher than that for the original Gas Sample. Staff reasons, therefore, that either the new sample is riskier than the Gas Sample, and thus less similar to Nicor Gas, or the average DCF estimate reflects a higher degree of measurement error. In either instance, Staff explains 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 would. Staff also points out that the results of Staff's analysis would be very similar if Keyspan and Southwest Gas were added to the Gas Sample without removing any other companies.

Staff also takes issue with Dr. Makholm's argument that published betas that are visible to investors are preferable when performing a CAPM analysis. Staff, on the other hand, believes that the validity of the methodology is a function of whether it is generally accepted as opposed to being readily visible. Staff maintains the superiority of its methodology by pointing out that the Commission has accepted it in numerous proceedings and that its based on the widely accepted Merrill Lynch methodology.

Staff asserts that Dr. Makholm's sustainable growth rate estimates are flawed. Specifically, Staff points to the "BR" and the "SV" components of Dr. Makholm's sustainable growth rate estimates. According to Staff, Dr. Makholm mismatched the higher return on *average* equity, RAV, with the higher *end-of-year* book value, Ve, which produces an overstated earnings estimate.

Moreover, Staff found Dr. Makholm's sustainable growth rate estimate to not only be internally inconsistent, but inconsistent with its application in Dr. Makholm's DCF model. The retention ratio Dr. Makholm calculated for the BR component of his sustainable growth rate is a forecast 2007-2009 retention ratio, but the dividend yield component of his DCF model incorporates dividend expectations for 2003-2007 as well as 2007-2009 and beyond. Dr. Makholm acknowledged that the 2007-2009 Value Line forecasts reflect a decreasing payout ratio. All else equal, a decreasing payout ratio produces lower dividend growth in the near term than the growth Dr. Makholm assumed. Staff asserts that Dr. Makholm combined in his DCF model the higher 2003 dividend yield, reflecting the higher near-term payout ratio, with a higher growth rate that reflects the lower 2007-2009 payout ratio.

The SV component of Dr. Makholm's sustainable growth rate estimates, which is intended to measure the expected growth from new common stock issuances, is also biased upward, due to his incorrect assumption that all new common stock will be issued at the prevailing market price, which Dr. Makholm estimated equals 1.9x book value. However, Dr. Makholm did not know whether all new common stock *was*, let alone *will be*, issued at a 90% premium to book value. In contrast, Mr. McNally explained that due to the use of stock options for officer and employee compensation, which are issued at prices below the prevailing market price, the 1.9x average book value to market value ratio assumed for Dr. Makholm's sample and the resulting sustainable growth rate estimates are upwardly biased. Moreover, Mr. McNally presented documents that show that at least some of the common stock issuances of

the companies in Dr. Makholm's sample were, in fact, exercised stock options. Since some of the new common stock is very likely to be issued at less than a 90% premium over book value, the SV component of the sustainable growth rate estimates is overstated. (ICC Staff Exhibit 5.0, pp. 36-37; ICC Staff Exhibit 14.0, p. 30)

Dr. Makholm's "Value Line" growth rate estimate, which equals the geometric average annual growth in a company's EPS from 2003 to Value Line's forecast EPS for 2007-2009, is also seriously flawed. Dr. Makholm made no attempt to normalize the base-year 2003 EPS data in his "Value Line" growth rate estimates, despite acknowledging the importance of normalizing those same earnings to calculate his sustainable growth rate estimates. Because EPS can fluctuate substantially from year to year, the EPS in any single year may be either above or below "normal." Thus, the implied growth rate can change significantly depending on the base-year selected. In this case, the record shows that the average return on equity for Dr. Makholm's sample is lower in the 2003 base year than the 2007-2009 forecast period.14 (Tr., pp. 275-277; Nicor Gas Exhibit 21.5) As a result, his Value Line growth rate reflects an unsustainable acceleration of growth. In summary, the average growth rate for the entire sample, upon which Dr. Makholm's cost of equity estimate relies, is inflated due to failure to normalize his base-year EPS data.

Staff also contends that Dr. Makholm disregarded the EPS growth rate estimates explicitly published by Value Line, which are imbedded in the Value Line EPS forecasts. Staff points out that the average of Value Line's published EPS growth estimates for the companies in Dr. Makholm's sample, exclusive of Nicor, Inc., is more than two full percentage points below the average of Dr. Makholm's calculated "Value Line" growth rates for the same five companies. Staff concludes that Dr. Makholm's decision to not normalize earnings at all has led to excessive growth rates

With regards to Staff witness McNally's growth rate analysis**,** Staff also refutes Nicor's criticism for the omission of growth rates based on Value Line data. According to Staff, Makholm's criticism is both disingenuous and baseless. Staff points out that Zacks investment services averages growth rate estimates from multiple sources to derive its growth rate estimates. Staff reasoned that it makes no sense for Makholm to simultaneously argue growth rates derived from Value Line data should be included in any cost of equity analysis because Value Line is perhaps the most popular and credible source of all while he himself declined to use the growth rates published by Value Line in his analysis and while criticizing Value Line's normalization methods. In other words, Makholm criticized Staff's analysis for not using a source that he himself criticized. Moreover, Staff points out that Makholm conceded that "a credible analysis should use all of the credible sources available," Dr. Makholm excluded from his final growth rate estimate the Yahoo! Finance growth rate estimates he included among his workpapers despite finding Yahoo! Finance to be a sufficiently credible source for growth rates for calculating the required return on the overall market used in his CAPM. Not surprisingly, the average of the Yahoo! Finance growth rates for Dr. Makholm's sample is lower than the average for any of the growth rates he employed. Finally, Staff asserts that Makholm's Value Line-based growth rate estimates themselves are severely flawed.

Staff points out that Nicor Gas has been assigned a credit rating of AA and a business profile score of 2 by S&P. Staff takes issue therefore with Dr. Makholm's proxy sample which has an average credit rating of A and business profile score of 2.5. According to Staff these numbers indicate that Nicor's proxy sample is significantly riskier than Nicor Gas. Dr. Makholm's failure, therefore, to make a downward adjustment caused him to overestimate the required rate of return on common equity for Nicor Gas.

Staff rejects Dr. Makholm's contention that because of Staff's Gas Sample's lack of comparability to Nicor Gas, Staff's 23 basis point adjustment to reflect the risk differential between the Gas Sample and Nicor Gas is unsound. Indeed, Staff maintains that his assertion, if correct, would support the need for just such an adjustment because the less representative the Gas Sample is of Nicor Gas, the greater the need for an adjustment.

According to Staff, Makholm's analysis is ignoring the risk/return tradeoff (i.e., investors require higher returns to accept greater exposure to risk). That concept forms the basis of Staff's adjustment. Staff acknowledges that Dr. Makholm is correct that credit ratings do not directly measure common equity risk but disagrees with his ultimate conclusion that there is no relationship between credit risk and equity risk. Staff asserts that equity costs are affected by debt leverage. S&P credit ratings are also affected by debt leverage. That is, as debt leverage rises, the cost of equity rises and credit ratings fall and vice versa. Thus, there is an inverse relationship between credit ratings and equity costs. While there is no way to directly measure that relationship, to ignore the significant risk differential indicated by Staff's Gas Sample's A rating and Nicor Gas' AA rating, as Dr. Makholm espoused, would clearly be inappropriate.

To further illustrate its position, Staff points to the difference between bondholders and equity holders. Staff explains that due to the contractual payment obligation of bonds, bondholders have a high degree of certainty that they will be repaid in a timely manner, whereas equity holders are entitled only to residual cash flows after bond payments are met. Staff, therefore concludes that the risk to a company's equity holders is clearly affected by the risk of default on its debt securities, as reflected in its credit rating.

Finally, Staff also highlights that Mr. McNally's approach in this proceeding is consistent with the approach the Commission has taken under similar circumstances in previous proceedings. (ICC Staff Exhibit 14.0, pp. 23-25; Order, Docket No. 98-0632, March 24, 1999, pp. 4-5; Order Docket Nos. 02-0798/03-0008/03-0009 (Cons.), October 22, 2003, pp. 80 and 89-90).

CUB/CCSAO

CUB-CCSAO, through its witness Christopher Thomas, proposes a rate of return on equity of 9.86%. CUB-CCSAO argues that Nicor overstates the appropriate investor-required rate of return on Nicor's shareholder equity. CUB witness Thomas' proposal is based on a discounted cash flow analysis of a diverse sample of expected growth rates for a group of comparable companies and is an appropriate estimate of the investor-required rate of return on Nicor's outstanding shareholder equity. Since Nicor Gas has a credit rating above that of comparable companies contained within this sample, so CUB-CCSAO's proposed ROE also includes a downward adjustment to recognize the different risk profiles of Nicor and the companies in the comparable sample.

CUB-CCSAO recommend an ROE in this proceeding near the bottom of the range of allowable rates of return for LDCs throughout the country as shown in Figure 1 on page 24 of Nicor Gas Exhibit 21.0. CUB/CCSAO witness Thomas subsequently updated his ROE estimate to reflect a quarterly Discounted Cash Flow analysis (DCF), consistent with the other parties to this proceeding, and to incorporate the risk adjustment proposed by staff witness McNally. These updates changed CUB/CCSAO's ROE recommendation from 9.94% to 9.86%, which is still greater than the lowest ROE shown in Figure 1.

According to CUB-CCSAO, its recommendation for an ROE near the bottom of the allowed rates of return for other utilities across the nation is justified by the evidence in the record. CUB/CCSAO points to Nicor's own testimony which touts its position as the lowest cost provider in the state of Illinois which means that management has been effective in keeping costs down. CUB/CCSAO further points out that Nicor's outstanding AA credit rating further demonstrates that investors view Nicor favorably. It is precisely because these factors, CUB/CCSAO reasons, which demonstrate that Nicor is less risky than other companies in the industry. As Staff witness McNally notes investors require higher returns to accept greater exposure to risk. Therefore, it is not surprising that Nicor's shareholders are entitled to a lower rate of return than other companies in the industry.

CUB/CCSAO's cost of equity analysis differs from Nicor's in four significant areas: (1) the respective growth rate forecasts; (2) the sample selection criteria; (3) stock prices; and, (4) downward risk adjustment.

The analysis performed by Mr. Thomas utilizes growth rate forecasts from Valueline, Zack's, and Reuters along with a retention growth estimate. CUB-CCSAO Ex. 1.0 line 262-63. Mr. Thomas utilized multiple growth estimates in order to gain an accurate picture about what investors expect the growth potential of each individual security to be and to reflect the variety of information that is available to investors in the marketplace. (*Id.* at lines 263-68.) While Nicor witness Makholm utilized the same sample of comparable utilities, he based his calculations on mismatched data from different time periods that produces a meaningless result in both his retention growth estimate and in his value line growth rates. To illustrate, in estimating his Valueline growth rates, Makholm chose to use the geometric average from 2003 because it resulted in the highest overall ROE. Staff witness McNally testified that because of this, "the average growth rate for the entire sample, upon which Dr. Makholm's cost of equity estimate relies, is inflated." (*Id.* at lines 739-41.) CUB/CCSAO further argues that the DCF analysis undertaken by Mr. Thomas is superior in that it utilizes corrected and updated growth rate forecasts from a diverse group of sources. (CUB-CCSAO Ex. 1.0 lines 208-11.)

With regards to the sample selection criteria**,** while CUB/CCSAO witness Thomas utilized the sample proposed by Nicor witness Makholm, disagreement exists over the proportion of each proxy firm's revenues from natural gas distribution operations in relation to each firm's total revenues. Witness Thomas maintained that the selection criteria proposed by Dr. Makholm should identify companies that reasonably approximate the risk characteristics of Nicor's gas distribution operations. Makholm, on the other hand, proposed criteria which excludes companies who earn less than 80% of their revenue from natural gas distribution operations. Witness Thomas maintains that a higher threshold for income from non-utility activities is appropriate. However, Mr. Thomas indicated that there is no strong financial theory that dictates specific criteria. Therefore, if the Commission determines that Dr. Makholm's sample is the most appropriate sample to use, then Mr. Thomas' proposed ROE should be adopted, as it utilizes consistent growth rates from a variety of sources to appropriately recognize the true investor required rate of return on common equity.

CUB/CCSAO witness Thomas further argues that using a 3-month average stock price is the most supportable approach to incorporate stock prices into a DCF analysis since evidence on the efficient market hypotheses seems contradictory. CUB-CCSAO Ex. 3.0 lines 264-68. Thomas utilized three-month average stock prices in order to balance the view that markets are efficient with the growing body of evidence that suggests that markets may not price securities appropriately in the short term. While Nicor witness Makholm asserts a preference for spot closing stock prices adjusted to reflect the timing of dividends in relation to the Ex-Dividend date, CUB/CCSAO contends that witness Thomas sufficiently demonstrated that Makholm's choice of an adjusted spot stock price estimate is not significantly different than the three-month average historically utilized by witness Thomas. CUB-CCSAO Ex. 1.0 lines 309-11. CUB/CCSAO's chosen methodology is superior in that it reflects different views of what the actual stock price might be. (*Id.* at lines 300-13.)

Finally, CUB/CCSAO believe that the 23 basis point downward adjustment proposed by Staff witness McNally is reasonable and necessary. CUB-CCSAO Ex. 3.01; CUB-CCSAO Ex. 3.0 lines 280-83. CUB/CCSAO agree with the notion that investors require higher returns to accept greater exposure to risk. Conversely, the investor-required return is lower for investments with less exposure to risk. Staff witness McNally's adjustment properly recognizes the relative credit ratings, a proxy for financial risk, of Nicor Gas and the samples of comparable companies utilized by the parties to this proceeding. According to CUB/CCSAO, the 23 basis point adjustment proposed by Mr. McNally reflects the spread between A-rated and AA-rated 30-year utility debt yields. In short, CUB/CCSAO believes McNally relied on a reasonable standard and urges the Commission to adopt it.

Commission Analysis and Conclusion

Nicor Gas, Staff and CUB/CCSAO all introduced evidence into the record designed to support their proposals on the appropriate ROE. While the parties disagreed over several aspects of their respective ROE calculations and methodologies, there are two critical areas of disagreement the Commission must resolve in order to determine the appropriate rate of return in this proceeding. The first is over the selection of comparable samples to serve as proxies. The second concerns whether Staff's proposed 23-basis-point downward adjustment was necessary in calculating a fair return on equity.

In order to accurately estimate the ROE of Nicor Gas, which is not publicly traded, it is necessary to identify a group of proxy firms with characteristics similar to those of Nicor's Gas distribution operations. The Commission believes the critical determination concerns what constitutes a reasonable proxy of comparable companies to compare to Nicor's gas distribution operations.

Staff's Gas Sample comprises eight cash dividend-paying, domestic, publicly-traded companies assigned an industry number of 4924 (i.e., natural gas distribution companies) within S&P's Utility Compustat database for which Zacks growth forecasts were available; that were not involved in any pending merger; and that derive 70% or more of their revenues from regulated gas delivery operations. Staff's criteria includes a lower revenue threshold and excludes companies earning less than 70% of their income from non-utility activities. Staff explains that the 70% threshold was selected to balance measurement error due to sample composition against measurement error due to individual company cost of equity estimates.

Nicor witness Makholm employed a sample of six dividend-paying publicly-traded companies that derive at least 80% of their operating revenues from regulated utility operations. Nicor's initial analysis was performed using data available as of September 17, 2004. Makholm subsequently updated his analysis using data available as of February 7, 2005. CUB/CCSAO adopted Nicor's proposed proxy group in this matter. *See* CUB/CCSAO Init. Br. at 27.)

The contested issue regarding the sample groups deals with the percentage of operating revenues that are derived from regulated utility operations. All of Nicor's proxy companies derive at least 80% of their operating revenue from regulated utility operations. Staff's elected revenue threshold for its sample group is 70%.

The Commission finds that the percentage of revenues derived from non-regulated business activities is an important criterion in the selection of an appropriate and comparable sample group. The gas sample must resemble Nicor Gas as closely as possible in order to accurately reflect the risks associated with the provision of gas distribution operations. When the companies chosen for the proxy samples were updated in February 2005, four out of the eight companies Staff had chosen to include in their proxy no longer qualified for their 70% revenue criterion. Staff's response that the proxy was valid despite the fact that the sample companies fell below the 70% threshold for 2004 is insufficient. The Commission does not agree that Staff's sample, from which half of the companies now fail to qualify for Staff's more relaxed threshold for unregulated revenues, is more representative than Nicor's sample, which remained intact under a more stringent standard. Accordingly, the Commission finds that the proxy group of six publicly-traded companies identified by Nicor and accepted by CUB/CCSAO better represent Nicor Gas and, consequently, allow the Commission to calculate a fair return for the utility.

Both Staff and Nicor used their sample groups in the DCF and CAPM models to estimate the Company's ROE. The aforementioned concerns with the robustness of Staff's sample also will be present in the proposed ROE that Staff derived therefrom. The Commission therefore looks to the results of the estimate derived from the sample proposed by Nicor and accepted by CUB/CCSAO. Nicor's proposed ROE of 10.82% is derived by averaging the results of its DCF and CAPM analyses. Nicor's DCF model estimated a 10.68% ROE while its CAPM analysis estimated a 10.95% ROE. These results are preliminarily accepted.

The respective DCF and CAPM calculations performed by the parties are also in dispute. Staff, in particular raises certain criticisms related to Nicor's ROE analysis. The Commission does not find that the issues raised seriously detract from Nicor's overall analysis nor do they serve to rehabilitate Staff's questionable proxy group.

Both Makholm and McNally computed their respective ROEs by averaging DCF and CAPM calculations. Both employed a quarterly version of the DCF model. The CUB/CCSAO witness updated his ROE estimate to reflect a quarterly DCF, consistent with the other parties to this proceeding. All used five-year growth rate data. Nicor witness Makholm employed Value Line DCF growth rates that Staff believes are questionable. Nicor responded by stating that Makholm's growth rate is derived from several credible and complementary sources including *The Value Line Investment Survey*. Nicor also points out that Staff's calculations not only relied on a single source for the growth rate but also did not utilize growth rates from The Value Line, which Nicor argues is considered the most reliable source of growth rates.

Nicor refutes Staff's criticism of Makholm's failure to use *Yahoo! Finance* growth rate estimates for the companies in his sample, despite using *Yahoo! Finance* information for other portions of his analysis. Nicor explains that the use of *Yahoo! Finance* data is not a requirement and also further explained that its witness prefers to utilize sources such as Value Line and Zacks.

Staff also took issue with Nicor's "dismissal" of beta estimates published by Zack's. Nicor explained that Makholm used published betas (such as Value Line) because they were visible to investors. The Staff calculated betas are not publicly available. There is no presumption that either Value Line betas or calculated betas are superior as long as the underlying calculation is valid. Clearly Messrs. Makholm and McNally both utilized different sources of data. As Staff correctly points out, the application of financial models and the analyst's informed judgment are both required in a cost of equity analysis. Because cost of common equity measurement techniques necessarily employ proxies for investor expectations, judgment is necessary to evaluate the results of such analyses. The rate of return analyst should attempt to replicate the thinking of investors, in developing their expectations regarding the growth in dividends.

Having identified a preliminary ROE, the Commission will consider the proposed adjustment to reduce the ROE by 23 basis points, or 0.23%. Staff contends that the reason for its 23 basis point downward adjustment is the notion of "risk/return tradeoff" from the investor's perspective. Equity costs are affected by debt leverage. As debt leverage rises, the cost of equity rises while credit ratings fall. In other words, there is an inverse relationship between credit ratings and equity costs. Staff's 23 basis point adjustment proposed by Mr. McNally reflects the spread between A-rated and AA-rated 30-year utility debt yields. CUB/CCSAO also adopts Staff's position and believes that the 23 basis point downward adjustment proposed by Staff witness McNally is reasonable and necessary. We agree.

The 23 basis point adjustment proposed by Mr. McNally reflects the spread between A-rated and AA-rated 30-year utility debt yields. Nicor Gas has been assigned a credit rating of AA and a business profile score of 2 by S&P. In contrast to Nicor Gas, Dr. Makholm's proxy sample has an average credit rating of A and business profile score of 2.5, which indicate that Dr. Makholm's sample is significantly riskier than Nicor Gas.

The Commission finds unpersuasive Nicor's contention that the 23 basis point adjustment is improper because it improperly mixes debt and equity risks. While the Commission agrees with Dr. Makholm that equity and debt are very different financial securities, the Commission does not find them mutually exclusive for purposes of determining an appropriate ROE in a rate case context. Nicor itself concedes that, "[L]ike all questions of affording a fair overall return, it is also about *how investors see Nicor Gas* . . . ." (Nicor Init. Br. at 85). Basic financial theory posits that investors require higher returns to accept greater exposure to risk, while the investor-required return is lower for investments with less exposure to risk. We agree with Staff that, while there is no way to directly measure the relationship between debt and equity, ignoring the risk differential in this context would be inappropriate. The Commission accepts that each proxy sample has its own inherent risk level that may differ from that of the target company. When the sample does not accurately reflect the total risk level of the target company, an adjustment is necessary and should be applied. This case is one of those instances. Standard & Poor's has assigned Nicor Gas a credit rating of AA and a business profile score of 2. Nicor witness Malkolm's proxy sample has an average credit rating of A and business profile score of 2.5 clearly making it more risky than Nicor Gas. The Commission finds that an adjustment is necessary to prevent Dr. Makholm's cost of equity for his proxy sample from overstating Nicor Gas' cost of equity.

The Commission reiterates that there is no proscription against the use of informed judgment in arriving at a final rate of return recommendation in a given case. The Commission requires that an analyst who departs from the results of his models must explain why he or she did so. The explanation must be rational and aimed at serving both the ratepayer and the shareholder by setting a return sufficiently high that the utility can attract capital, but not so high that it earns an excessive return. In this instance, Mr.

McNally sufficiently explained how and why he adjusted the ROE downward by 23 basis points to reflect the spread between A-rated and AA-rated 30-year utility debt yields.

Finally, as Staff correctly points out, the downward adjustment being applied is consistent with the approach the Commission has taken under similar circumstances in previous proceedings. (98-0632 (Mar. 24, 1999), 4-5; 02-0798/03-0008/03-0009 (Cons.) (Oct. 22, 2003), 80, 89-90).) In short, we find that Staff witness McNally sufficiently demonstrated that the 23-basis point downward adjustment is justified. The adjustment is, therefore, adopted.

In summary, the Commission finds Nicor's proxy group to be superior to Staff's and a more accurate reflection of Nicor Gas for ratemaking purposes. The Commission also finds Staff's proposed downward adjustment of 23 basis points to be reasonable. Nicor's ROE is therefore set at **10.59%** (10.82% originally proposed by Nicor minus Staff's proposed adjustment). While several of the parties discussed whether flotation costs should be recoverable in the "cost of equity" section of their legal briefs, the Commission addresses that issue separately in the next section of this Order.

Flotation Costs

Nicor

Nicor proposes to recover its flotation costs in the amount of $4, 695,771.

According to Nicor, the record shows that these costs have not been recovered before and that they were incurred for utility purposes. To support its claim, Nicor points to undisputed evidence in the record which includes sworn testimony based on the witnesses' review of Nicor Gas' audited books and records, original equity issuance documents, rate filings made with the Commission, annual reports to the Commission, and the Commission's own rate orders demonstrating that Nicor Gas has incurred issuance costs and that those costs have not been recovered. (Mudra Reb., Nicor Gas Ex. 20B.0, 39:899 – 41:930; Mudra Sur., Nicor Gas Ex. 36.0, 23:506 – 24:524). Nicor cites prior Commission precedent that allowed for the recovery of these costs. (*See* Nicor Init. Br. at 100 (*citing* 92-0292 (July 21, 1993), 1993 Ill. PUC Lexis 245 at *127.)

Nicor disputes staff witness McNally's contention that Nicor Gas "failed to demonstrate either that the remaining costs it seeks to recover through rates were incurred for the benefit of Nicor Gas utility operations or that those costs remain unrecovered." (McNally Reb., Staff Ex. 14.0, 9:161 – 163). According to Nicor, this assertion ignores the evidence simply has no basis in the record. Nicor also takes issue with staff witness McNally's observation that two issuances were made by "Nicor Inc." (McNally Reb., Staff Ex. 14.0, 10:180 – 181). Nicor asserts that his observation is immaterial because Nicor Gas is only seeking to recover the percentage flotation cost applicable to Nicor Gas' equity capital. There is no doubt that the equity contribution to Nicor Gas was used for utility purposes. Nicor concludes that these issuances by Nicor Gas' holding company properly establish the historical percentage and issuance cost for equity capital used by Nicor Gas. (Mudra Sur., Nicor Gas Ex. 36.0, 22:490 – 23:494)

Nicor further argues that Staff has not articulated any type of evidence that they would consider sufficient. Nicor proceeds to cite to the law of uncontradicted evidence. According to Nicor, in a contest rate case the Commission is required to apply the law governing uncontradicted evidence. (Nicor Gas Init. Br. at 78-79, 102) The Supreme Court of Illinois has held that: "Where the testimony of a witness is neither contradicted, either by positive testimony or by circumstances, nor inherently improbable, and the witness has not been impeached, that testimony cannot be disregarded by the trier of fact." *Bazydlo v. Volant*, 164 Ill. 2d 207, 215, 647 N.E.2d 273, 277 (1995) *Thigpen v. Retirement Board of Fireman's Annuity and Benefit Fund of Chicago*, 317 Ill. App. 3d 1010, 1021, 741 N.E.2d 276, 284 – 85 (1st Dist. 2000) (citing *Trahraeg Holding Corp. v. Property Tax Appeal Board*, 204 Ill. App. 3d 41, 44, 561 N.E.2d 1298, 1300 (2d Dist. 1990)). Therefore, the uncontradicted evidence in the record and Commission precedent illustrate that the Commission should allow the flotation cost adjustment proposed by Nicor Gas.

In sum, Nicor Gas believes it has presented substantial evidence demonstrating that issuance costs have been incurred for utility purposes and have not been recovered. In the absence of evidence to the contrary, Nicor reasons that the Commission should follow its precedent and allow the flotation cost adjustment proposed by Nicor Gas.

Staff

Staff opposes the recovery of flotation costs on two specific grounds.

First, Staff asserts that Nicor Gas has failed to demonstrate that it has incurred but not recovered the fees upon which its flotation cost adjustment is based. Staff initial Brief at 92. Staff points to prior Commission precedent to support its claim. The Commission Order from Commonwealth Edison Company, Docket No. 94-0065, states that "The Commission has traditionally approved [flotation cost] adjustments only when the utility anticipates it will issue stock in the test year or when it has been demonstrated that costs incurred prior to the test year have not been recovered previously through rates." Moreover, that Order states that "[the utility] has the burden of proof on this issue." Thus, flotation costs are to be allowed only if a utility can verify both that it has incurred the specific amount of flotation costs for which it seeks compensation and that those costs have not been previously recovered through rates. According to Staff, the Company has not done either.

Second, the Company's flotation cost adjustment calculation does not accurately reflect the costs it claims it has incurred but remain unrecovered. Staff takes issue with Dr. Makholm's flotation cost adjustment which reflects $4,142,661 of underwriting discounts and commissions as well as $454,000 of estimated other issuance expenses related to five issuances, totaling $173,364,332 of proceeds.

Staff points out that the Company has failed to provide any documentation to demonstrate that all $4,142,661 of underwriting discounts and commissions were *incurred* for the benefit of Nicor Gas; it has provided no documentation to demonstrate that the $454,000 of estimated other issuance expenses were even *incurred* at all. Furthermore, the Company provided no documentation to demonstrate that either of those costs remain *unrecovered*, aside from the $478,277 of discount on common equity recorded in Account 214, which, as discussed previously, the Commission has found to be insufficient for that purpose. Moreover, Dr. Makholm calculated his 2.54% adjustment factor by dividing his $4,596,661 total flotation cost estimate by the $173,364,332 total proceeds for five issuances rather than dividing by the full $648,156,000 balance of equity in the Company's proposed capital structure. Staff, therefore, reasons that Dr. Makholm's methodology actually produces an adjustment that reflects an even higher level of flotation costs than the $4,596,661 total flotation costs that form the basis of his adjustment, which the Company has neither demonstrated to have been incurred for the benefit of Nicor Gas rate payers nor remain unrecovered.

Attempting to further fortify its position, Staff engaged in a thorough review and analysis of Nicor's recent rate case history. Staff points out that 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.)

Staff found that 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. 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.

Staff also points to a recent non Nicor Rate Case Order as further supporting its position on flotation costs in the case at bar. Staff points out that 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. (Order, Docket No. 91-0193, March 18, 1992, p. 106.)

In short, Staff asserts that its prior rate case analysis on this issue reveals that 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.

Staff also argues that Nicor Gas' flotation cost adjustment 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. (Illinois Bell v. Illinois Commerce Commission, 283 Ill.App.3d 188, 207 (1996)) (Staff Init. Br., at 94).

The Company's inclusion of the Nicor Inc. issuances in its calculation of Nicor Gas' flotation costs is definitely not 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 (Staff Init. Br., at 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.) 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.

Finally, Staff points out that the Company's estimate of its flotation cost expenses is inconsistent. 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.)

CUB/CCSAO

CUB/CCSAO also advocates for a Commission denial of Nicor Gas' flotation costs. CUB/CCSAO characterizes Nicor's flotation costs as "backwards looking" and points out that they date as far back as 1961 as well as the fact that they were issued under a different name. (CUB/CCSAO Init. Br. at 29-30.) According to CUB/CCSAO, it would be inappropriate for the Commission to incorporate these previously incurred costs into a forward-looking cost of capital, since they aren't anticipated to occur during the period in which the cost of capital would be in effect. The Company indicated that it currently has no plans to issue additional equity.

CUB/CCSAO points out that Nicor conceded in its brief the fact that two of the issuances it proposes as a basis for its flawed flotation cost adjustment were made by "Nicor Inc.," but argues that it is immaterial because Nicor Gas is only seeking to recover the percentage flotation cost applicable to Nicor Gas' equity capital. (Nicor Init. Br. at 102.) CUB/CCSAO refutes Nicor's argument that these issuances, whether undertaken by the gas utility or its holding company, properly establish the historical percentage selling and issuance costs for equity capital used by Nicor Gas. Instead, CUB/CCSAO argue that Nicor is incorrect to refer to these costs as a percentage selling and issuance cost because these are known and fixed dollar costs. (*See* CUB Ex. 3.04.) According to CUB/CCSAO, Nicor is simply trying cloud the record and inflate its allowed rate of return by incorporating these previously incurred costs into a forward-looking cost of capital. The effect of incorporating these costs as a percentage of forward-looking capital costs is an unwarranted and inappropriate increase in Nicor's allowed rate of return.

Commission Analysis and Conclusion

Nicor proposes that the Commission increase its rate of return by including an adjustment to recover stock issuance expenses, or flotation costs, that it claims have been previously unrecovered. The issuances date as far back as 1961.

The central inquiry for the Commission here is whether Nicor Gas has demonstrated that it has incurred, for the benefit of Nicor Gas ratepayers, but not yet recovered, the fees upon which its flotation cost adjustment is based. More specifically, the sole issue is whether the evidence set forth by Nicor is sufficient to satisfy its burden in this instance. We do not believe it is.

The utility bears the burden under Section 9-201(c) of the Act to prove that the recovery of flotation costs is just and reasonable. (*See* 220 ILCS 9-201(c)). The Commission in the past has treated flotation costs in various ways, depending on the specifics of the record in each case. The Commission has allowed a flotation cost adjustment when the evidence shows that the utility *has incurred expenses that have not been recovered*. (92-0292/92-0357 (cons.) (July 21, 1993).)

Further, Section 9-230 of the Act addresses the Commission's approach toward calculating a rate of return where potential financial transactions with non-utility or unregulated companies may exist. Specifically, Section 9-230 provides, in relevant part:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (i) incremental risk, (ii) increased cost of capital, … which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.

(220 ILCS 9-230.) Consistent with its previous decisions and treatment of flotation costs, the Commission believes that it is appropriate to allow a flotation cost adjustment *to the extent that the evidence shows* the utility has incurred issuance expenses that have not been recovered. With this legal framework in mind, the Commission now turns to the evidence presented on this issue.

The Company claims that it or its predecessors, since the inception of Nicor Gas as an independent utility in 1953, had five public issuances of equity for which it now seeks recovery. The primary evidentiary basis for Nicor's request to recover flotation costs is witness testimony. According to Nicor, the testimony is based on the witnesses' review of Nicor Gas' audited books and records, original equity issuance documents, rate filings made with the Commission, annual reports to the Commission, and the rate orders demonstrating that Nicor Gas has incurred issuance costs and that those costs have not been recovered.

As a threshold matter, the Commission is perplexed as to why Nicor failed to produce the documents it references when it states its witnesses own sworn testimony "is based on the witnesses' review of Nicor Gas' audited books and records, original equity issuance documents . . .etc." A careful examination of the record reveals that the *only* actual documentation the Company provided comprises of copies of excerpts from its annual reports to the Commission that show $478,277 of discount on common equity recorded in Nicor Gas' annual reports each year since 1973.

While that may be considered some evidence in the event Nicor was seeking to recover issuance costs for the past twelve years, it is insufficient when it seeks to recover issuance costs dating as far back as 1961, as they propose in this proceeding. The record clearly indicates, and Staff pointed out, that the Commission accounting rules did not require Illinois utilities to amortize common stock expenses that were recovered through rates until December 31, 1993 (i.e., the year the Uniform System of Accounts was amended to require that only unrecovered common stock expenses were to be recorded in Account 214). As such, it is not possible for the Commission to ascertain the validity of these accounting entries prior to 1993. In other words, the Commission is not able to determine whether Nicor's entries from 1973 to 1993 have actually been recovered or not. The Commission has previously addressed this very same issue in a recent rate case. In Docket 99-0534, the Commission rejected MEC's proposed common equity flotation cost adjustment, even though MEC had recorded the costs in Account 214. Noting that Commission rules did not require utilities to amortize common stock expenses that were recovered through rates until December 31, 1993, the Commission stated that it could not conclude that all of the issuance expense recorded in Account 214 remained unrecovered. (99-0534 (July 11, 2000), 35-36.)

Nicor concedes on the record that two specific issuances at issue were made by Nicor Inc. yet it is Nicor Gas that seeks their recovery. (Nicor Reply Brief at 120). According to Nicor, the fact that the two issuances were made by Nicor Gas' parent is "immaterial" since Nicor Gas is only seeking to recover the percentage flotation cost applicable to Nicor Gas' equity capital. We disagree. Section 9-230 of the Public Utilities Act is clear in its proscription of calculating a rate of return where financial involvement with non-utility or unregulated companies is possibly intermingled with flotation costs at issue as is the case here. (*See also* Ill Bell v. ICC, 283 Ill.App.3d 188, 207 (1996)). Moreover, as CUB/CCSAO witness Thomas correctly points out, it is disingenuous for Nicor to refer to these costs as a *percentage* selling and issuance cost when, in essence, these should be known and fixed dollar costs.

Nicor also asserts that Staff, while disputing Nicor's evidence, has failed to articulate any type of evidence that it would consider sufficient for flotation cost recovery. The Commission reminds Nicor that Staff does not have the burden to prove cost recovery in this proceeding; Nicor does.

Finally, Nicor cites and emphasizes the case law concerning uncontradicted evidence. According to Nicor, in a contested rate case, the Commission is required to apply the law governing uncontradicted evidence. The Supreme Court of Illinois has held that: "Where the testimony of a witness is neither contradicted, either by positive testimony or by circumstances, nor inherently improbable, and the witness has not been impeached, that testimony cannot be disregarded by the trier of fact." *Bazydlo v. Volant*, 164 Ill. 2d 207, 215, 647 N.E.2d 273, 277 (1995) *Thigpen v. Retirement Board of Fireman's Annuity and Benefit Fund of Chicago*, 317 Ill. App. 3d 1010, 1021, 741 N.E.2d 276, 284-85 (1st Dist. 2000).

The Commission does not disagree with these legal principles. What Nicor is missing, however, is that its burden under Section 9-201(c) is a prerequisite to the application of its "law of uncontradicted evidence" principle. Nicor's burden was to introduce into the record persuasive evidence that the issuance costs sought for recovery had actually been incurred in the specific amount being requested *and* that those costs have not been previously recovered through rates. The Commission finds they have fallen short in this regard. In the event Nicor had produced this evidence and it had indeed been uncontradicted, then Nicor possibly would be in a position to prevail under the "uncontradicted evidence" standard.

In short, the Commission finds that the documentation presented by the Company is inconclusive in establishing that issuance costs remain unrecovered. Nicor has not met its burden and, therefore, is not entitled to the recovery of any flotation costs in this proceeding.

Approved Rate of Return on Rate Base

As discussed above, the Commission finds that it is appropriate to exclude short-term debt from Nicor's capital structure. The Commission also adopts a 10.59% cost of common equity for reasons discussed above. Upon incorporation of the conclusions contained above, Nicor's capital structure and cost of capital, resulting in overall cost of capital of 8.90% may be summarized as follows:

Class of Capital	Share	Cost	Weighted Cost
Long-Term Debt	43.51%	6.72%	2.92%
Preferred Equity	0.12%	4.77%	0.01%
Common Equity	56.37%	10.59%	5.97%
Total	100.00%		8.90%

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

Cost of Service Study

Marginal Cost Of Service Study

Nicor originally advocated a marginal cost of service study (MCOSS), but subsequently accepted the use of an ECOSS to allocate the revenue requirement. (Nicor Init. Br. at 105.) Accordingly, the MCOSS is no longer at issue. The Company further avers that "[m]arginal cost principles nonetheless should be applied to Nicor Gas' rate design, especially in the setting of tail block charges for multi-blocked rates and in customer charges other than the Rate 1 customer charge." (*Id*. at 106.) Individual rates will be addressed subsequently.

Embedded Cost Of Service Study

Nicor

For the purpose of the instant case, Nicor advocates that the ECOSS allocate costs according to the Modified Distribution Main (MDM) study and the Average and Peak (A&P) method. Nicor does not accept use of Staff's ECOSS for this purpose, arguing that it makes arbitrary and unsubstantiated changes to peak day usage by class and inappropriately modifies the MDM study. Also, Nicor avers that Staff's position is not consistent with the 1995 rate case Order. Nicor asserts that its most recent ECOSS (*See* Nicor Ex. 42) should be chosen. Nicor maintains that its original ECOSS is superior because it uses the CP method rather than the A&P method, but agrees to use the A&P method narrows the issues. Both studies however, use the MDM study.

Nicor states that its MDM study is an engineering study that assigns distribution mains-related costs to its customer classes based on cost-causation. The MDM determines peak day flows for each size of distribution main, as well as the portion of peak day flows attributable to each rate class. The Company asserts that it followed the same methodology approved in its 1995 rate case (*see* 95-0219 at 49), and that no party identified an error in the methodology.

The Company contends that Staff's ECOSS alters customer class peak demands, making it inappropriate for revenue requirement allocation purposes and for rate design. As a result, it does not use the correct peak day for each customer class, and inappropriately alters the MDM study by reallocating the distribution mains investment in the study. As a result, the cost and revenue allocations are understated for residential customers and to General Service customers—Rate 1 and Rate 4 respectively.

CUB/CCSAO's ECOSS, like Staff's original ECOSS, does not use the MDM study at all, which suggests to Nicor that each rejects the most accurate information regarding the cost-causation of the largest dollar element of Nicor Gas' gross and net plant. Nicor argues it also does not correctly use the A&P method, because it weights the average or volumetric portion of the allocator more than the system load factor. The ECOSS that correctly uses the MDM study and the A&P method, if the A&P method is to be used, is the Nicor Gas ECOSS presented in the surrebuttal testimony of Mr. Heintz (Nicor Ex. 42.1). Also, the CUB/CCSAO ECOSS fails to use the A&P method properly. Mr. Thomas' creation of an intercept through his regression analysis is not a valid load factor to use in the A&P.

IIEC's ECOSS uses the MDM study, but suffers from other flaws. IIEC's ECOSS is less accurate than the Nicor Gas' ECOSS in terms of the changes it makes relating to storage costs and Storage Banking Service revenues. IIEC continues to lower the base rate revenue requirement with Nicor Gas' Hub revenues, as opposed to including the revenues in Rider 6. Hub revenues fluctuate from year to year and are more accurately returned to customers through Rider 6, as opposed to a one time adjustment to base rates.

Staff

Nicor witness Heintz updated the MDM Study used in 95-0219 to allocate distribution mains costs based on peak day demands. According to Staff, the Company explained that the relationship of base use and heat use factors for estimating peak day demand for Rates 1, 4, 10, and 11, are based upon a 79 Heating Degree Day ("HDD"). Added to the Maximum Daily Contract Quantities ("MDCQ") for rates with daily metering, peak day demands from the Company's rate classes totaled 50,478,799 therms, or 5,047,880 MmBtu. Nicor projects a 52,580,000 therm or 5,258,000 MmBtu system design peak day. To account for the difference between 5,280,000 and 5,047,880 MmBtu, the Company allocated an additional 18.49 percent to Rates 1, 4, 10, and 11. According to Staff, the 18.49 percent increase to Residential and Commercial demands also compensated for the Company's reduction to 30 percent of the 6,048,000 therms MDCQ for Rates 17 and 19 down to 1,830,000 therms (ICC Staff Exhibit 16.0-Revised, p. 11, ll. 224-228). Staff contests the MDM Study's reliance upon Coincident Peak ("CP") to allocate distribution mains costs, as well as Nicor's calculation of rate class demands to allocate distribution mains usage among the rate classes.

Staff witness Luth disagrees with the Company's demand cost allocation among customer classes. Since the Company projected Rates 1, 4, 10, and 11 based upon base use and heat use on a 79 HDD, and other classes based upon their MDCQ, Staff argues that peak demands for Rates 1, 4, 10, and 11 are overstated. The MDCQs as of March 31, 2004 for rate classes with daily metering were established based upon 2003 calendar year data, during which the coldest day was only 61 HDDs. Thus, lower projected peak demands would have resulted for Rates 1, 4, 10, and 11 if based upon the same 61 HDDs that represented the coldest day for the MDCQ measurements. Staff contends that, because projected peak demands of Rates 1, 4, 10, and 11 are already based upon a 30 percent colder HDD than the MDCQs, adding 18.49 percent balance to Rates 1, 4, 10, and 11 overweights their share of peak day demand.

Since peak demand costs are allocated through the MDM Study, Staff notes the importance of relative customer class peak demands. If the peak day demands of one or a few customer classes are overstated relative to other customer classes, costs allocated according to demand will be excessive for the customer classes with overstated demand and will subsidize the other customer classes. It therefore is necessary to remove the additional 18.49 percent from the peak demand that the Company charges to Rates 1, 4, 10, and 11.

Staff also argues that Rate 17 and 19 contract customers should be charged a greater share of demand costs, because a typical year will not have a 79 HDD day (Confidential Nicor Workpaper ("WP") (285.315)6), and therefore it will not be necessary for Nicor to curtail deliveries to those customers to the full extent in a typical year. To allocate distribution mains appropriately, the MDM study should be refined to recognize the appropriate relative customer class demands resulting from Staff witness Luth's adjustments to the peak demands calculated for Rates 1, 4, and 17.

Mr. Luth applied the results of his adjusted MDM Study to approximately 73.24 percent of distribution mains costs. The remaining 26.76 percent of distribution mains costs were allocated according to the share of average throughput from each customer class during the test year. The 73.24 demand/26.76 average throughput allocation represents the system load factor using Mr. Luth's "sum-of-the-parts" approach to determining relative customer class peak demands, and also represents the Average and Peak ("A&P") approach to allocating transmission and distribution costs. Docket 95-0219 applied the MDM Study in that docket to 70 percent of mains costs, with 30 percent of mains costs allocated according to throughput.

Staff asserts that, although Nicor and IIEC disagree with the Staff adjustment to relative customer class peak demand, Nicor does not object to the allocation of transmission and distribution costs according to A&P. Staff notes that IIEC argues for the allocation of costs through the MDM Study based upon CP. Staff explains that allocation of mains costs solely upon CP is inconsistent with previous Commission Orders (95-0219, 49; 04-0476, 64-65; 02-0837, 90-91; 94-0040). According to Staff, no party has shown that there is a direct relationship between increases in demand and increases in mains costs. Since the MDM Study allocates distribution mains costs, the A&P should be included in applying the results of the MDM Study.

Staff recommends the use of A&P to allocate transmission and distribution costs, which also includes costs allocated through the MDM Study. Nicor does not object to the use of A&P, but objects to Staff's adjustment of peak demand. IIEC continues to object to the use of A&P and also objects to Staff's adjustment of peak. Staff argues that 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 usage.

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. Such costs cannot be fully explained by differences in demand, however. 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. (04-0476, 65; 94-0040, 65-67.)

Staff states that there is a cost component to having the gas transmission and distribution system in place throughout the year. Heavier users of the system should pay at least some of the costs incurred by 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. 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. Thus, Staff contends the Commission should continue to allocate transmission and distribution costs based upon the A&P.

CUB/CCSAO

CUB/CCSAO assert that the various ECOSS proposed by both Staff and Nicor misallocate the costs of transmission plant and distribution plant, including distribution mains and associated expenses. Nicor's ECOSS relies on a flawed MDM Study, and even the updated MDM presented by Mr. Luth does not fix the problem. The Commission should reject any study relying on CP methodology. Mr. Thomas opined that such a methodology overallocates distribution main costs to residential customers and should be rejected.

Nicor agreed to accept an A&P methodology that incorporates the MDM study to estimate the peak portion of costs. Yet averaging the results of a cost study based on cost allocations grounded in cost causation (an A&P analysis) with cost study results that pretend that all delivery costs are incurred and caused only by peak day demands (Nicor's MDM) does not produce a reasonable estimate of allocated costs. Staff witness Luth adjusted the MDM demand allocation factors to correct this inaccuracy. While Mr. Luth's study fixes one problem with the MDM, it still relies on the CP methodology, and therefore remains inappropriate. If the Commission believes that the coincident peak allocation methodology is inappropriate, then there is no need to utilize the MDM study for any purpose.

CUB/CCSAO maintain that allocation is a critical aspect of an appropriately performed ECOSS, and an appropriate allocation needs to recognize that the system is designed to meet peak capacity but is utilized throughout the entire year. A utility cannot justify its transmission and distribution investment on demands for a single day. (94-0040 at 138-39.)

Nicor's use of CP for certain costs measures only the demand on the system on peak days, and does not measure the use of the system on the vast majority of days other than peak days. Some customer classes use the system more heavily throughout the year; Mr. Luth testified that they "should be expected to pay for the use of the system based, at least in part, on the use of the system throughout the year, rather than how the system is used on only a few days each year." (Staff Exhibit 16.0 ll. 273-77.) The CP methodology fails to recognize the fact that different customer classes place different demands on the system and should therefore be rejected.

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

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

The Company recognizes that mains are installed based upon factors other than demand on the peak day. According to Mr. Harms, investment in mains depends upon expected revenue generated compared to the cost of the investment and expected expenses. (*See* Tr. 755.) Given the actual tariff language filed by Nicor and interpreted by Mr. Harms, CUB/CCSAO argue that the total annual usage of each customer is relevant. Accurate cost causation analysis would recognize that factors other than peak day demand cause costs. Mains are installed to meet varying demand throughout the year and Nicor's CP methodology fails to recognize this fact.

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

Mr. Thomas compared actual throughput for the 12-month period ending December 2004 with the average and coincident peak information utilized by Nicor's ECOSS in the creation of his A&P allocator. The average of the total system throughput data is 45.44% of the peak month, while the daily average data is only 23.1% of the coincident peak data. Mr. Thomas's regression analysis indicates that the appropriate A&P allocation factor is 37.5%. Thus 37.5% of costs should be allocated on the basis of average demand and the remaining 62.5% should be allocated based upon peak demands. Nicor argues that since the R-squared of Mr. Thomas's analysis is low, the entire analysis should be disregarded. CUB/CCSAO counter that the value of the analysis is not diminished by the result that time does not explain the variation in throughput.

CUB/CCSAO also argue that peak usage should be Nicor's actual throughput on the peak day. Nicor inappropriately considers only firm peak throughput on the peak day. On the peak day, interruptible customers still receive some level of gas service. These customers should be responsible for the costs they cause, but are not under the Company's study. The amount of gas that flows to these customers on the peak day still places a demand on the system, and should therefore be recognized in allocating costs.

IIEC

According to IIEC, the issue concerns the ECOSS and what underlying methodology to use. IIEC notes that, over the course of the case, eight ECOSS have been developed with a variety of methodologies. IIEC urges adopting a ECOSS based on the CP method and the MDM study. IIEC also suggests that rate increases should be as gradual as possible.

IIEC asserts that the MDM study more directly assigns the responsibility of distribution mains to individual classed than the CP and A&P allocation methods. They explain that the MDM study recognizes that gas generally flows from larger main to smaller mains, and that not all classes use the smaller diameter main. Neither the CP nor A&P method, which depend upon generic relationships between usage patterns and cost causation, achieve this level of granularity. IIEC notes that the MDM study was accepted by both the Commission and the Staff in Docket 95-0219.

The CP methodology, according to IIEC, is premised on the fact that transmission and distribution mains must be large enough to accommodate the maximum possible use on a design day. The cost responsibility for the mains that are jointly used by all classes is allocated in proportion to each class's share of the system design day peak. IIEC contends that this allocation method best reflects cost causation. IIEC also notes that the CP method for allocating Nicor's demand-related costs was used prior to the 1995 rate case.

The A&P method is a weighted average of two allocation factors, the coincident peak factor (i.e., the CP) and an average demand allocator. IIEC argues that average demand is annual volume divided by 365 days, and thus is a volumetric allocator. IIEC avers that volume is not a factor; if a system can accommodate peak demand, it must also accommodate average demand. IIEC therefore concludes that the A&P method dilutes the primary cost causative factor, coincident demand.

If the Commission gives weight to average demands in the allocation of distribution mains, there are two possibilities. The first possibility is the method used by Mr. Heintz and Mr. Luth in their version of the A&P method. As noted by Mr. Heintz, he allocated 76.9% of the distribution mains on the basis of the MDM study and allocated the remaining portion strictly on the basis of volume. IIEC contends that volume is not a cost-causative factor, and volumetric allocation makes no distinction between sizes of mains. It indiscriminately allocates all sizes of mains to all customer classes based on volume. However, if a class does not use 2 inch mains on a peak day, it will also not use 2 inch mains on an average day. IIEC concludes that mixing the MDM study with a volumetric allocator will produce improper results.

The second method, according to IIEC, is to modify the MDM study to include average loads as well as peak loads. Just as the original MDM study is a matrix, which shows how much of each class's peak day usage flows through each size (diameter) main, one could just as readily construct an analogous matrix using average loads. The A&P MDM allocator would be a weighted average of the two matrices with a 76.9% weighting for the peak day matrix and a 23.1% weighting for the average day matrix. In this way, average day flows could be introduced into the allocation process, without violating the fundamental theme of the MDM study, i.e. that different customer classes do not use all sizes of mains with the same relative intensity.

IIEC asserts that the MDM study is the most accurate way to assign costs related to distribution mains, and that CP is the most accurate method for assigning transmission and distribution plant not assigned by the MDM. Staff's adjustment to MDM should be rejected, however, because it is based on the incorrect premise that peak day use by Rate 1 and Rate 4 customers is measured at a higher heating degree day usage level. IIEC explains that peak day use by other customer classes is adjusted to the same heating degree day level as the Rate 1 and 4 customers, so Staff's adjustment inappropriately shifts costs from Rate 1 and Rate 4 customers to the other customer classes. IIEC also criticizes the CUB ECOSS for failing to incorporate the MDM and for determining a statistically insignificant A&P allocator. IIEC opposes the A&P methodology, but states that if it is adopted, Nicor's ECOSS is the least inappropriate application of it.

Commission Analysis and Conclusion

The underlying issue is the method that best allocates transmission and distribution demand costs to those that cause them. The Commission notes that the MDM study was accepted in the previous rate case (*see* 95-0219 at 49) and its use in the instant case is supported by Nicor, IIEC, and Staff. The arguments offered by IIEC against Staff's adjustment to the MDM study (*See* IIEC Reply Br. at 4-6) are well-reasoned and persuasive, and the Commission rejects that adjustment. CUB/CCSAO argue against the MDM because it relies on CP methodology. The Commission does not agree that this renders the MDM fatally flawed, however; the Commission notes IIEC's comment that CP methodology is one of the two factors considered in the A&P methodology that CUB/CCSAO support.

The next consideration is whether to use CP or A&P to allocate transmission and distribution costs not assigned by the MDM study. IIEC advocates the CP method, asserting that A&P misallocates costs away from small volume customers to industrial users. Nicor prefers CP but has accepted A&P in its latter two ECOSS. Staff and CUB/CCSAO argue for the A&P method. The Commission accepted A&P rather than CP in Nicor's previous rate case, stating that "some T&D investments are not peak-related." (95-0219, 49.) The A&P methodology also has been adopted in subsequent rate cases for other utilities. (*See* 03-0008/03-0009 (cons.) (Oct. 22, 2003) at 98 ("In light of the nature in which the transmission and distribution systems are used and because of the relatively declining cost of increasing capacity, peak demand is not the appropriate emphasis in allocating demand costs. * * * The A&P method properly emphasizes the average component to reflect the role of year-round demands in shaping transmission and distribution investments."); *see also* 04-0476 at 74-75; 02-0837, 90-91.)

IIEC argues that Nicor's system would be inadequate if it relied on the A&P method to meet system demand. The Commission does not find this argument persuasive, because A&P is being used to allocate the costs of the system among rate payers, and not for engineering purposes. Also, the Commission rejects IIEC's contention that A&P inappropriately considers average demand costs. The Commission has previously determined that "a utility can not justify its transmission and distribution investment on demands for a single day." (03-0008/03-0009 (cons.) (Oct. 22, 2003) at 98, citing 94-0040 at 138-139.)

After considering the various ECOSS studies offered by the parties and the arguments regarding their respective methods, the Commission accepts the ECOSS methodology offered by Nicor in the surrebuttal testimony of Mr. Heintz. (*See* Nicor Ex. 42.1.) That study best uses the MDM study and the A&P method, and is the appropriate ECOSS for setting rates in this case. The IIEC ECOSS does not use the A&P method, and takes a position with respect to the SBS charge which the Commission declines to adopt, (*See infra*). The CUB/CCSAO ECOSS does not use the MDM, and additionally relies on a statistically insignificant regression to estimate an allocation factor for the A&P method. The Staff ECOSS, presented in the rebuttal testimony of Mr. Luth, utilizes an incorrect design-day demand total, and thereby improperly adjusts the MDM. The Commission views the remaining ECOSS presented earlier in Nicor direct and rebuttal testimony and in Staff direct testimony to be superseded by those in Nicor surrebuttal and Staff rebuttal testimony.

Rates, Riders, and Other Terms and Conditions

Rate 1

Nicor

Nicor proposes a customer charge and three block volumetric charge for the approximately 1,950,000 residential customers served under Rate 1. The Company states that its rate design, which would increase the customer charge from $6.00 to $8.40, recovers more of the fixed costs of service through the fixed customer charge. Nicor proposes to set the tail block rate at marginal cost, employ a declining block structure over the three volumetric delivery charge blocks, and moderate the fixed customer charge somewhat by capping the increase at 40%. Nicor also asserts that its structure recovers an amount very close to that suggested by its ECOSS and MCOSS. The Company notes that CUB/CCSAO generally support its rate design.

Nicor notes that its three block declining rate design for Rate 1 was approved in its previous rate case. Nicor recommends against Staff's two-step declining block rate, which the Company views to approximate a single flat rate. The Company asserts that it would provide poor price signals to customers, would make customers' bills more weather-sensitive, and would expose the Company to a risk of under-recovery of its allowed revenue requirement. Finally, the Company contends that AG witness Effron proposes to alter the billing determinants for Rate 1, but has not sufficiently justified its proposal.

Staff

Based on its ECOSS, Staff recommends a monthly customer charge, and a slightly declining two-block distribution rate. Staff proposes to recover slightly more than the full Rate 1 cost of service, although its proposed customer charge, at $8.00 is slightly lower than Nicor's. Staff states that Rate 1 revenues recovered over Rate 1 cost of service contribute to an underrecovery of the cost of service for Rates 17 and 19. Staff notes that the Company did not propose revisions to Contract Rates 17 and 19.

Staff recommends a nearly flat two-block distribution rate. Staff avers that its simpler rate structure is more easily understood by consumers. Staff opposes any significant reduction in rates at higher usage blocks. Staff asserts that, under the Company's proposed declining three-block distribution rates, the higher demand would be billed at more discounted unit rates. Staff disagrees with the Company that Staff's proposal would increase the volatility in customer bills, and points out that the main source of volatility is the commodity cost of the gas. Staff concedes that its rate proposal will result in higher bills for distribution service, but views the difference as insignificant.

AG

According to the AG, Nicor has forecast an increasing number of residential customers, but has forecast the sales to residential customers to decrease from 2004 to 2005. The AG asserts that sales to residential customers and the pro forma base rate revenues from sales to those customers should be adjusted.

The AG relies on a Nicor assumption that:

> Customer additions were forecast to be 34,200 in 2005, of which 95.1 percent are expected to be residential, 4.7 percent commercial and .2 percent industrial. Delivery growth attributable to these anticipated new customers and commercial/industrial process changes is expected to more than offset a forecast load loss due to natural gas conservation.

(Nicor Sched. G-5 at 2.) The AG asserts that Nicor's assumption that growth attributable to new customers will more than offset load loss due to conservation efforts, conflicts with the Company's projected decrease in residential sales of 17,937,000 therms. (Nicor Sched. E-4.) Nicor noted business conditions, business closings and persons/entities moving out of the area as other possible reasons for declining sales, but the AG contends that these are not assumptions listed on Schedule G-5.

AG witness Effron forecasts growth in residential sales of 27,953,000 therms based on an assumption that the growth in sales from 2004 to 2005 will equal the weather normalized growth in sales from 2003 to 2004. The AG contends that Company witness Harms failed to explain his own forecast adequately or to rebut that of Mr. Effron.

CUB/CCSAO

The residential rate structure proposed by Nicor is a reasonable compromise between cost reflection, feasibility, and gradualism. CUB/CCSAO state that the Company's proposal moves toward cost-based rates, while moderating the effect of the increase. They maintain that this is the most reasonable option available to the Commission. They maintain, however, that Nicor has not demonstrated that marginal cost-based rates will offer an improvement in efficiency.

CUB/CCSAO urge the Commission to reject Staff's proposed rate design because it failed to incorporate any degree of gradualism to limit the rate shock to residential customers. In addition, CUB/CCSAO maintain that Mr. Luth did not consider the effect that his rate design would have on residential end users who use either significantly more than or significantly less than the average usage for each rate class.

Vanguard

Vanguard contends that Nicor uses non-residential classes of customers to subsidize residential customers. Vanguard asserts that Nicor's proposed rate design for residential customers and non-residential customers fails to assign costs to those that create them. Vanguard submits that Nicor's use of a customer charge cap is arbitrary. The Commission should reject Nicor's proposed tariff structure and instead apply a cost-causation rate design. This action will result in a rate design for both residential and non-residential customers that reflects cost-causation principles and is equitable. Transportation customers have borne the burden of other rate classes, specifically the residential class, for at least the past ten years, and the Commission should not permit this arbitrary and inequitable situation to continue.

Commission Analysis and Conclusion

Nicor proposed that Rate 1 consist of a fixed monthly customer charge, the gas cost determined in accordance with Rider 6, and a three-block declining rate structure for distribution charges. The Commission accepts this general structure. The alternate design proposed by Staff replaced the three-block declining distribution rate with a nearly flat two block distribution rate. The Commission concurs with the Company that an essentially flat distribution rate would increase the weather sensitivity of Rate 1 customers. Staff points out that the commodity cost of gas poses a much larger potential for weather sensitivity and other price spikes. Even so, the Commission does not believe that a rate design that unnecessarily enhances weather sensitivity should be adopted.

Nicor proposes to cap the increase in the flat monthly customer charge at 40%, raising it from $6.00 per month to $8.40 per month. The Company asserts that its proposal will allow it to recover more of its fixed costs in the flat monthly charge, while moderating the impact of the rate increase. Vanguard contests the cap on the Rate 1 customer charge, urging that only cost causation should be considered. The Commission rejects Vanguard's argument, finding it consistent with the arguments made against A&P methodology in the ECOSS.

The Commission concurs with the AG that the Company failed to justify its forecast decrease of 17,937,000 therms. The Company contends that the AG's position is unsupported, but it fails to state why the analysis is incorrect. Accordingly, the Commission rejects Nicor's estimate of test year residential sales of 2,256,096,000 therms, and accepts the AG's estimate of 2,301,985,000 therms.

The Commission accepts Nicor's proposed customer charge of $8.40 and three block structure. The rates for the three block structure shall be set according to the ECOSS adopted *supra*. Within the results of the ECOSS, the Commission finds that declining block pricing for the latter rate blocks is appropriate. The first block rates should not be increased from the amounts originally proposed by the Company, however, unless an increase to the first block is necessary to avoid an essentially flat rate structure.

Issues Related to Rates 74, 76, 77 and Rider 16

Rates 74, 76, and 77 are Nicor's tariffs for firm transportation service. Transportation customers purchase their own gas, and can purchase storage service on the Nicor system. At issue in this proceeding is the level of flexibility and freedom Transportation customers should be allowed and the costs associated with providing service to Transportation customers. Customers selecting an alternative supplier through the Customer Select program take service under Rider 16. As discussed in the sections immediately below, several issues are common to Transportation customers and Customer Select customers.

Storage Capacity Allocation

Storage Banking Service ("SBS") is a service offered to Transportation customers that allows them to serve all or part of their demands from supplies of gas that they have previously stored in Nicor's storage fields. Each eligible customer has the right to elect, up to a certain guaranteed amount for an annual period, the amount of SBS it wishes to take.

The amount of SBS to which each Transportation customer is entitled has been based on each individual customer's ("MDCQ"). The MDCQ is the maximum amount of gas that the customer can require Nicor Gas to deliver on a given day. In Docket 95-0219, the Commission established the SBS entitlement at 26 times a customer's MDCQ. Since the MDCQ is not measurable for Customer Select customers, the storage entitlement for these customers is based on estimates made by Nicor.

Nicor

It is Nicor's position that the SBS entitlement should be reduced from 26 to 23 times a customer's MDCQ in this proceeding. Nicor claims it used the formula approved in Docket 95-0219, the estimated amount of gas to be cycled during a year divided by the estimated peak day sendout for the entire system to produce the 23 times MDCQ. Nicor indicates that a conforming change is also proposed to the level of storage allocated to each Customer Select Group under Rider 16.

According to Nicor, there was general agreement among the witnesses and parties as to the use of the methodology from Nicor's last rate case. Nicor avers that there was also agreement as to the denominator in the calculation: Nicor's peak day sendout is approximately 52,580,000 therms. The disagreement among parties relates to the numerator in the calculation. Nicor claims the numerator should be 120 Bcf, which it avers that represents the amount of gas Nicor expects to cycle in a year.

Nicor avers that other parties proposed using higher values for the numerator, including 149.74 Bcf, which was intended to represent the sum of non-coincident capacity of Nicor's eight storage fields. Nicor argues that using 149.74 Bcf for the storage allocation numerator would be incorrect. According to Nicor, 149.74 Bcf is the non-coincident capacity – the total working gas of each storage field, even though they reach their maximum capacity level on different days. Nicor claims it does not represent the capacity of the system as a whole at any particular time. Nicor asserts that, to use total working gas instead of estimated gas actually cycled, the coincident maximum volume should be used—132 Bcf in 2004.

According to Nicor, total working gas—even the coincident total—is not the correct figure. Nicor states that total working gas is an amount which, under ideal conditions, Nicor theoretically could draw out of its fields and reinject over the course of a year. Nicor claims that one of those ideal conditions is that Nicor would be able to draw its working gas down to zero before beginning to inject gas to meet its requirements for the following season. Nicor states that this is something that it cannot prudently do, however, since it is not prudent for Nicor to run its supply of gas down to zero.

Nicor states that the ability to deliver gas at a given rate is directly related to the amount of gas in the fields. Nicor asserts that it must maintain its maximum deliverability from storage of 2.5 Bcf in a single day, as late as January 20 of the season. Nicor claims that, after that date, it can begin to let withdrawals overtake injections but must be able to meet other, lower deliverability targets, as late as mid-March. According to Nicor, to meet its required working gas targets late in the withdrawal season, Nicor will always have some gas in storage when it comes time to begin injecting for the following season.

Nicor avers that Transportation customers are free to withdraw all their gas before Nicor Gas' design day (January 20), refill their storage, and withdraw it all again by April 1. Nicor adds that Transportation customers do not need to consider the necessary reservoir pressures to achieve a target deliverability, and do not face a reduction in the amount of gas they can withdraw, so long as they have gas in storage. According to Nicor, Transportation customers do not have to worry about these cycling issues. In Nicor's view, because the 120 Bcf figure best represents the actual amount of gas that Nicor will cycle in a given year, it is the most appropriate figure for the storage allocation.

Nicor claims that Dominion is attempting to obtain an allocation that is out of proportion to other customers on the Nicor system. Nicor avers that its annual sendout is approximately 500 Bcf. Nicor states that applying Dominion's 38% figure across the board to the entire sendout, would call for 190 Bcf in allocated storage, which is more on-system storage capacity than Nicor has. According to Nicor, this indicates that Dominion is laying claim to more than a fair share.

According to Nicor, Dominion witness Mr. Crist attached some draft rules that cover on-system storage assignment, based on another LDC's rules, which Mr. Crist believed were more favorable to Dominion than Nicor's rules. Nicor asserts that Mr. Crist had modeled his rules on those of Dominion East Ohio, an affiliate of Dominion. Nicor avers that it would be preferable to address proposed rules in a separate Illinois proceeding, rather than adopt the rules applicable to an Ohio LDC and its affiliate.

Nicor also states that Staff's suggestion to use total coincident maximum working gas, could be a reasonable compromise position. Nicor claims its total coincident working gas was 132 Bcf in 2004 and would result in a calculated storage capacity allocation of

25 times MDCQ (132 Bcf / 5.258 Bcf), a slight reduction from the current level of 26 days. Nicor asserts that Staff witness Mr. Borden overlooked Nicor's reclassification of working gas to base gas, so he used the wrong number in his calculation, and this was not corrected in Staff's Initial Brief.

Nicor avers that CNE requests that Transportation customers continue to be allowed incremental leftover storage capacity allocations if SBS is not fully subscribed. Nicor avers that customers are guaranteed to be able to get an allocation of up to 23 times their MDCQ and they can request a higher level. Nicor adds that they can request higher than that, and if SBS is not fully subscribed, they may obtain a higher allocation. Nicor believes this satisfies CNE's request. Nicor states that SBS allocations occur before capacity is allocated to the Hub. Nicor adds that Hub transportation and storage services are interruptible, and use unfilled storage space that typically has been allocated to and subscribed by SBS customers. Nicor states that interruptible Hub services do not, therefore, reduce the amount of firm storage capacity available for allocation to SBS customers.

Staff

Initially, Staff concurred with Nicor's proposal to reduce the SBS capacity entitlement from 26 times a customer's MDCQ to 23 times MDCQ as being consistent with that approved in the Company's previous rate case. However, after reviewing the alternative proposals reflected in the direct testimony of IIEC/CNE, Dominion, and Vanguard on this issue, as well as the Company's rebuttal testimony, Staff witness Borden recommended that the Commission maintain the MDCQ approach to the allocation of storage entitlements because he believes it links the allocation of storage costs to the use of storage capacity at peak times. Mr. Borden proposed that the SBS entitlements be based upon the historical average for the coincident peak working gas in storage ending in 2004.

Staff witness Borden's calculations indicated that the three year, five year, and ten year historical averages for the coincident peak working gas in storage resulted in similar MDCQs for SBS entitlements. For rounding purposes, Staff witness Borden recommended that the MDCQ entitlement be increased from its current 26 times the customer's MDCQ to 27 times MDCQ.

In response to Nicor's concern that Transportation customers today can withdraw all of their storage before the design day of January 20, refill it and withdraw it again all before April 1, Staff states that if this type of cycling of gas is problematic, then Nicor's approach should be to revise its withdrawal rates and cycling parameters, rather than reduce storage capacity because, historically, Nicor's system has been capable of far greater use of storage on peak days than is afforded from Nicor's proposal. Staff maintains that the three year, five year, and ten year historical coincident peak withdrawals from storage resulted in SBS capacity of 27 times the MDCQ. It is Staff's position that the coincident peak withdrawals indicate that Nicor's storage facilities can afford more storage capacity to Transportation customers than what Nicor proposes, and the Commission should adopt Staff and the IIEC's recommendation of 27 times the MDCQ.

IIEC

In IIEC's view, the underlying concept is that the amount of SBS approved should be commensurate with the amount of storage apportioned between Sales customers and Transportation customers. IIEC takes issue with Nicor's use of 120 Bcf as the numerator in the calculation as well as the resulting 23 times customer MDCQ as the SBS entitlement.

IIEC states that working gas is the amount of gas that can be effectively injected and withdrawn from the storage fields. IIEC argues that if Nicor, for its own operational considerations, chooses to cycle less than that amount, that is a separate issue and should not serve as a rationalization to reduce the capacity available to Transportation customers.

It is IIEC's position that the working gas, 149.74 Bcf, is the appropriate numerator. IIEC states that using 149.74 Bcf as the numerator produces an SBS entitlement of 28 times customer MDCQ.

IIEC indicates that Staff witness Mr. Borden, in his rebuttal testimony, performed his own analysis and recommended an allowance of 27 times MDCQ as the SBS entitlement. IIEC believes that while Mr. Borden's reasoning has merit, IIEC nevertheless supports the conclusion of Dr. Rosenberg that 28 times MDCQ is appropriate.

According to IIEC, if the Nicor witness on this subject states 149.740 Bcf is the amount available, and this is the amount that can be effectively injected and withdrawn in a storage cycle, and this is the amount that Nicor charges customers for, it should also be the amount that Nicor uses for the calculation of the SBS charge.

With respect to Nicor's statement that its coincident maximum storage volume was 132 Bcf in 2004, IIEC avers that Nicor does not propose to use this amount as the numerator in the calculation of the SBS capacity entitlement. IIEC adds that the 132 Bcf figure was derived from only one year of data and the average maximum single day working gas capacity for the 1999-2004 time period was approximately 143 Bcf, while the equivalent figure for the 1995-2004 time period was 139.5 Bcf. In IIEC's view, if the Commission accepts Nicor's arguments that 149.74 Bcf is not really the amount of gas that is available to be filled by top gas, the Commission should direct the use of no less than 140 Bcf as the numerator in the formula for the SBS capacity entitlement.

IIEC disputes Nicor's argument that it is not appropriate to use the coincident peak capacity in the SBS capacity formula because it represents the amount of gas that could be injected and withdrawn under ideal conditions. IIEC avers that one of those conditions would be the ability to withdraw working gas down to zero and that Nicor reasons that drawing working gas down to zero would not be prudent. In IIEC's view, Nicor's argument is a red herring. IIEC contends that the issue here is the appropriate level of storage capacity to calculate an SBS charge which IIEC avers that is applied on a capacity basis. IIEC argues that if the charge is to be imposed on the basis of maximum capacity, it is appropriate to use the actual maximum capacity of the Nicor storage fields, not the amount of gas Nicor expects to cycle in a given year.

IIEC asserts that the Nicor argument also fails to recognize that while Transportation customers pay for a specific amount of maximum capacity, they do not draw down their storage gas volumes to zero. IIEC maintains that it is appropriate to calculate the maximum amount of storage capacity a Transportation customer will be entitled to on the basis of the maximum capacity of the Nicor storage fields.

IIEC argues that if Nicor insists that the SBS charge be calculated on the basis of the amount of gas that Nicor intends to cycle in and out of storage rather than on the basis of the actual capacity of the storage asset, then the Commission should apply the SBS charge to the amount of gas Transportation customers will cycle in and out of the storage fields rather than a customer's maximum capacity. IIEC avers that Nicor opposes such an approach.

CNE

It is CNE's position that the record fails to support Nicor's proposals to reduce a customer's SBS entitlement to 23 times the customer's MDCQ. Citing the testimony of IIEC/CNE witness Dr. Rosenberg, CNE claims that the record supports an increase in the SBS capacity entitlement to 27 times the customer's MDCQ.

CNE argues that contrary to Nicor's assertions, it is appropriate to allocate physical capacity instead of its estimated amount of gas that will be cycled. According to CNE, the SBS capacity entitlement is an entitlement of capacity. CNE asserts that the 120 Bcf figure used by Nicor is not a capacity figure but its expected cycling figure.

According to CNE, Dr. Rosenberg and Staff witness Borden agree that the appropriate capacity figure on which to base the capacity entitlement SBS number of days is between 140 Bcf and 149 Bcf. CNE states that Staff witness Borden settles on 140 Bcf as the average coincident peak for working gas in storage over the past 10 years for Nicor Gas's storage fields.

CNE states Nicor would have the Commission believe that any number higher than 120 Bcf threatens its system's operations and thereby reliability to Sales customers. CNE contends this argument is a red herring. CNE asserts that while Nicor acknowledges that using coincident peak capacity makes some sense, it offers little to rebut the Staff and IIEC/CNE alternative proposal.

CNE also takes issue with Nicor's argument that it is prudent not to cycle its entire gas in storage, but rather it needs to "keep something in the tank." CNE claims that Nicor does not have a single storage field, but operates with eight separate storage fields. In CNE's view, it a prudent driver had eight separate gas tanks, it would fully cycle a single tank to empty, just as long as it did not run all eight tanks to empty at the same time. CNE believes Nicor should be able to cycle a volume that is greater than 120 Bcf of gas.

CNE argues that for the past 10 years, Sales customers have not been disadvantaged due to Transportation customers' access to 26 times their MDCQ. CNE contends that Nicor has failed to meet its burden of justifying the fairness and the reasonableness of a proposal to reduce Transportation customers' SBS capacity entitlement.

CNE requests that the Commission reject Nicor's proposal to reduce the number of days times MDCQ. If the Commission determines that it should change the number of days times MDCQ, CNE maintains that the record supports adoption of the use of 27 days.

CNE also objects to the storage allocation proposal of Dominion, which is described further below. As an initial matter, CNE asserts that Dominion did not present any record evidence to support either raising or lowering transportation storage and, for this reason alone, the Commission should reject Dominion's argument on this issue.

According to CNE, Dominion claims its proposed allocation methodology would result in only 23,879,394 units of storage remaining for both transportation and Hub Services, which CNE asserts is actually less than what the entire transportation class alone had in storage as of October 31, 2004. It is CNE's position that Dominion's proposal would have significant ramifications for Transportation customers. CNE recommends that the Commission reject Dominion's proposal.

<u>RGS</u>

According to RGS, it is axiomatic that since on-system and up-stream assets are paid for by all customers through base rates, Nicor should not discriminate between Transportation, Customer Select, and Sales customers in the assignment of on-system storage. RGS avers that the Commission should accept Nicor's proposal to reduce Customer Select Suppliers' critical day storage rights only if Select and Transportation Suppliers' storage rights are maintained. RGS states that Nicor has proposed to reduce the allocation of Select and Transportation Suppliers' working storage gas from the existing 26 times MDCQ level to 23 times their MDCQ and further has proposed to reduce the critical day storage withdrawal factor for Select Suppliers from .023 to .021. RGS believes Nicor has failed to adequately justify either proposal, and reducing both would be a "double penalty" to Customer Select and Transportation suppliers.

RGS states that, as a comprise, it proposes that if the current level of 26 times MDCQ is maintained to determine storage rights for both Customer Select and Transportation, then the Retail Gas Suppliers would be willing to accept the reduction from .023 to .021 as the factor to determine withdrawal rights on a critical day.

In RGS' view, Nicor's proposed reduction in the storage allocation from 26 times to 23 times MDCQ is particularly inappropriate. RGS states that using Nicor's own numbers, the appropriate number of heating degree days should be increased to at least 27 times MCDQ. RGS also states that this assessment of heating degree days is supported by Staff, although other parties have presented even higher numbers, or advocate using different means to calculate allocation altogether.

RGS states that while it does not disagree that other means can be used to calculate the allocation, utilization of a formula that is based upon MDCQ can be appropriate, if the proper factors are used. According to RGS, since the working gas is a component in Nicor's calculations regarding storage allocation, it is important to use the proper storage number of 149.7 Bcf. RGS recommends adopting the storage number of 149.7 Bcf, producing the proper number of heating degree days should be 28 times MDCQ, and therefore, a reduction is not warranted. RGS believes that such a reduction, if coupled with the reduction of withdrawal rights proposed by Nicor, would equate to a withdrawal reduction, below what the system is capable of handling, and would result in an inequitable allocation of storage.

RGS contends that Nicor has presented no evidence that justifies the use of the cycled gas estimate of 120 Bcf instead of the actual working gas number of 149.7 Bcf and there is no reason for the Commission to approve Nicor's request to change the current allocation factors.

RGS suggests that in the event the Commission determines that a change in the allocation and peak day withdrawal factors should be made, the Commission should not reduce both the storage allocation factor and the peak day withdrawal factor. RGS believes that such parallel changes would dramatically reduce both allocation and withdrawal rights below current and equitable levels. RGS states that by maintaining the current level for allocation at 26 times MDCQ, some of the impact of the withdrawal rights reduction would be mitigated. According RGS, while such a reduction would reduce significantly the amount of storage that could be utilized on a peak day, it would keep withdrawal rights within the withdrawal limits of the system, and would be in line with Nicor's own withdrawal experience.

According to RGS, if Nicor's proposal is accepted by the Commission, the Company would collect $18,543,000 from Customer Select and Transportation customers for working capital on gas in storage, without actually allocating the storage to these customers. RGS states that Nicor has argues that as a result of a negotiated solution in Docket 00-0620 (Cons.), it "has adjusted its administrative account charge from $1.03 to $.059 to provide a credit of $.044 per month per account for the gas storage inventory working capital [to Customer Select customers]." RGS claims that parties in that proceeding recognized that it was not appropriate to charge Customer Select customers for the working capital cost of gas in storage, since Customer Select customers pay for their own storage, and Sales customers' carrying costs through their suppliers' commodity costs. RGS argues that Nicor is now asking for an increase in base rates to include an increase in the working capital on gas, in storage cost, without a corresponding increase in the credit to Customer Select customers.

RGS contends that while Customer Select and Transportation customers would pay for additional working capital costs of gas in storage and a portion of the $18 million storage carrying costs, Nicor is requesting that Customer Select and Transportation storage allocation be reduced from 26 to 23 MDCQ. According to RGS, Nicor is arguing for the reduction in gas allocation to Customer Select and Transportation customers because it will still make its rate of return on the additional working gas in storage if the proposed reduction is approved; the more costs Nicor is permitted to include in base rates, the more Nicor benefits through its rate of return. RGS adds that with additional assets to manage, Nicor and its affiliate operating the HUB would have additional assets to offer via its HUB services.

It is RGS' position that in determining the SBS entitlement, the Commission should reject Nicor's proposed "estimate" of 120 Bcf of working gas in favor of using the "actual" figure of 149.7 Bcf. According to RGS, although Nicor admits that the total amount of on-system storage is approximately 149.7 Bcf, and admits that this amount of gas can be injected and effectively recovered during a storage cycle, Nicor asserts that only its estimate of cycled gas should be considered when making decisions regarding storage capacity allocation. RGS argues that Nicor's estimate of its cycled gas is not fully reflective of the assets that should be used as the basis for allocation decisions.

RGS asserts that in attempting to make a distinction between working gas and cycled gas, Nicor is actually proposing that a "working reserve of gas" or "rollover gas" be created as a distinction between working and base gas. RGS characterizes this as gas that, although it can easily be withdrawn from storage as working gas, Nicor anticipates retaining it as additional reserves. RGS complains that Nicor does not propose to reduce the charge to customers related to this rollover gas storage allocation, but rather proposes to require all the gas storage to be paid for through base rates to the level of working gas.

It is RGS' position that since all customers pay the costs associated with the entire storage field through base rates, all customers should get the benefit of the entire working field when determining the proper allocation of storage. RGS argues that Nicor's estimate of 120 Bcf ignores the fact that Nicor and Customer Select Suppliers find it necessary or practical to keep gas in storage for operational purposes and that a reduction in the initial allocation will not reduce the amount of gas that Suppliers will "roll over" to the next season. RGS states that pursuant to the Tariffs, Customer Select customers are required to maintain 3 times MDCQ in storage from season to season. RGS contends that Nicor's estimate of 120 Bcf of gas to be cycled improperly counts twice gas that is rolled over to the next season.

RGS claims that under Nicor's proposal, Customer Select Suppliers' "rollover" gas would be counted twice, first by reducing the initial allocation and second by keeping 3 times the MDCQ in storage. RGS further asserts that by reducing the allocation of actual working storage below the 149.7 Bcf level, Customer Select Suppliers would be forced to reduce storage twice, to a level well below that for which they pay.

RGS insists that the 149.7 Bcf of top gas or "working gas" identified by Nicor is appropriate for use in establishing the SBS entitlement. It is RGS' position that, from an asset allocation perspective, simply because Nicor has anticipated cycling only 120 Bcf of storage in any given season does not mean that the assets for which customers pay should be reduced. RGS believes that to treat Transportation customers in a non-discriminatory manner, it is necessary to use the total capacity of the working gas or top gas of the storage fields to determine proper storage allocation, which is not the same as the 120 Bcf anticipated cycling gas figure. RGS also claims that even if Nicor's argument for a "coincident peak" were accepted, the least that could be used would be 140 Bcf.

RGS further argues that by unnecessarily reducing the SBS entitlement allocation to Customer Select and Transportation customers, Nicor's proposal would limit the ability of those customers to access storage during higher utilization periods, thereby artificially increasing the demand for off-system assets. RGS contends that Nicor's reduction of the working gas pool used in the numerator of the calculation also serves to increase the assets that Nicor has to manage for the Sales customers above what the Sales customers pay for, and/or creates additional assets for Nicor to provide to its affiliate for HUB services.

It is RGS position that by eliminating the pro rata share of the 29.7 Bcf from the SBS entitlement allocation formula, Sales customers effectively would receive a windfall share of storage for which they do not pay. RGS adds that if the additional assets are not utilized by Nicor for the Sales customers, then the assets are being used to provide the HUB services. In RGS' view, taking the assets paid for by Customer Select and Transportation customers and using those assets for either Sales or HUB services would create an inequitable subsidization of Sales customers at the expense of Customer Select and Transportation customers.

RGS recommends that the Commission utilize an equitable allocation, capacity utilization, and revenue distribution so that no customer group is compelled to subsidize another. RGS recommends that the Commission reject Nicor's working gas proposal, and instead use the entire 149.7 Bcf of working gas for the purpose of determining the SBS entitlement allocation.

Dominion

According to Dominion, there are two aspects to storage allocation. The first is the total storage capacity to be allocated. The second is how that total storage is allocated among classes. Dominion asserts that Nicor has underestimated the amount of storage available for assignment and it has favored the Sales class over Customer Select class in the allocation of that storage.

Dominion states that Nicor proposes that it allocate 120 Bcf (approximately 121,000,000 MmBtu) to storage and that Nicor's proposal is based on Nicor's projection of the volume of capacity that Nicor expects to cycle in a normal year. In Dominion's view, the problem with Nicor's method is that weather is never "normal" and Nicor does not plan for normal weather.

Dominion asserts that in four of the last five heating seasons, actual withdrawals exceeded the amount of storage proposed by Nicor for allocation. Dominion contends that Nicor's normal projection does not reflect actual system capabilities. Dominion argues that Nicor has the ability and has shown the willingness to withdraw more from storage than the figure it calculates on estimated usage. It is Dominion's position that the storage allocation should be based on actual maximum storage capability, which could be approximated by actual use over a recent period of time. Dominion claims that because Nicor's ratepayers paid for the full storage capacity, and it exists to address system needs on cold days, then Nicor should calculate available storage base actual maximum system usage, not a lesser "expected" number in normal winters.

Dominion states that other parties in the case argue that storage should be allocated on maximum system capacity, which is close 149,000,000 MmBtu. Dominion adds that after reviewing all parties' testimony on this issue, Dominion agrees that figure should be used to determine storage allocations. Dominion concludes that although total storage capacity figure should be no less than 135,950,706, Dominion believes the Commission should accept the higher figure of 149,000,000 mmBtu.

Dominion disputes Nicor's assertion that parties such as Dominion have proposed that Nicor should use a higher numerator to reflect the amount of gas that Nicor could "in theory" draw out of storage. Dominion chose a figure of 135 Bcf, which was the amount that Nicor withdrew during the winter of 2001-2002. Dominion contends that this was not an anomaly because Nicor withdrew more than 120 BCF in four out of five winters.

In Dominion's view, the bottom line is that every Nicor customer pays for a slice of the overall seasonal storage capacity on the Nicor system and every customer should get the benefit from their share. Dominion asserts that Nicor wants to limit overall storage so it can run the Hub and have a buffer for itself. Dominion argues that it does not matter whose physical gas is in Nicor's storage because each day Nicor will still use the storage gas it needs to meet system demand. According to Dominion, the issue here is not operations; it is accounting, and Customer Select suppliers should be provided their proper accounting level of storage.

Dominion contends that Nicor also erred in the way it has allocated storage between Sales customers and Customer Select customers. Dominion claims Nicor has allocated its storage in a manner that allows Sales customers to meet more of their gas supply needs from storage than Customer Select customers. Dominion asserts that its baseload consumption analysis showed that approximately 34% of the gas used by Sales customers is used during winter months in excess of their average monthly use during a full year. According to Dominion, Customer Select customers had an almost identical pattern, with 35% of their use in winter months being in excess of their baseload usage. Dominion state that Transportation customers, which are less temperature sensitive, used only about 12-14% of annual requirement in excess of baseload.

According to Dominion, using either baseload consumption analysis or total consumption results, Sales and Customer Select groups have very similar usage patterns. In Dominion's view, those two classes should be allocated a similar amount of storage to meet that winter load in excess of baseload consumption. Dominions avers that under Nicor's proposal however, Sales customers will obtain 37.2% of their annual requirements from on-system seasonal storage capacity and Customer Select customers will only obtain 29.1% of their annual requirements from on-system seasonal storage capacity. Dominion claims there is no reason why these two classes of customers should have different storage allocations.

Dominion argues that the usage patterns of the two groups are identical – greater winter use due to heating. It is Dominion's position that providing Sales customers with a larger percentage of storage service allows Nicor a greater opportunity to minimize their gas costs than it provides to Customer Select suppliers. Dominion estimates that this discrepancy in storage provides Sales customers with a $0.09 per decatherm savings relative to Customer Select customers. Dominion contends that because both classes pay the same amount for storage, those savings are inherently inequitable and result in a cross subsidy of Sales service by Customer Select service.

Dominion recommends that the Commission equalize the storage capacity of Sales and Customer Select by allocating sufficient storage to each class so that they can obtain the same amount of their annual requirements from storage. Dominion suggests that using the highest most recent storage cycling amount, Sales service should be allocated 38.1% of its annual consumption and Customer Select service should be allocated the same percentage of 38.1%.

Dominion states that Nicor assumed Dominion was recommending that Transportation customers also be allocated sufficient storage to meet 38.1% of their annual needs from storage, and criticized Dominion for proposing a system with storage withdrawals in excess of Nicor's maximum storage capacity. Dominion asserts that is not correct. Dominion claims it only proposed raising the Customer Select storage figure up to reflect actual withdrawal patterns. Dominion avers that it made no proposal to raise or lower Transportation storage.

Dominion believes movement away from MDQ as a means of allocating storage for Customer Select customers is appropriate because the MDQ is not measurable by customer for Customer Select customers and instead relies on an estimate made by Nicor. According to Dominion, if Nicor must use the MDQ, it should use a figure that approximates the 38.1% figure. Dominion estimates that increasing the on-system storage capacity to the 38.1% level would require raising the MDQ basis to 34.11. Dominion adds that Customer Select customers must maintain three times their MDQ in storage at all times, and this amount is not available for withdrawal. Dominion argues that, as a result, the effective storage for Customer Select customers is actually less than the amount Nicor claims it has have available. Dominion contends that Transportation customers do not have this requirement.

Dominion states that if implementation of its proposal requires reduction of storage from another class, it should come from the Hub. Dominion asserts, that while Nicor tries to defend the Hub as essentially interruptible service that is subservient in both injections and withdrawals to other classes of customers, Nicor irrevocably allocates a portion of its storage to the Hub.

According to Dominion, there is a need for more storage for Customer Select service, to place it on an even level with Sales service access to storage. Dominion maintains that

Nicor could also allocate more storage to Sales and Transportation service, with the knowledge that based on previous experience, some customers will not use their entire allocation. Dominion argues that Nicor should not allocate a firm amount of storage to the Hub. Dominion contends that Nicor's on-system gas storage has been funded by ratepayers – Sales, Customer Select and Transportation – through the rates they pay.

Dominion argues that giving away any portion of that storage to the Hub is therefore the improper diversion of an asset. Dominion claims that Nicor should reduce the allocation to the Hub to zero, and reallocate that storage to the customers that paid for it. According to Dominion, if the purpose of the Hub is to exploit excess capacity that the primary customers do not use, then that is how it should operate. In Dominion's view, it should not be provided with a set amount of on-system storage capacity. Dominion asserts that other utilities operate quite well without the use of anything equivalent to the Hub and Nicor could operate without it.

In Dominion's view, if the Hub is allocated any storage, it should come from Sales customers, because, under Nicor's current proposal, that is the only class that will receive revenues from Hub operations. Dominion believes that requiring Transportation and Customer Select customers to take less storage so that the Hub can operate – while flowing all profits through to Sales customers – creates a cross subsidy of Sales customers.

Dominion argues that regardless of how Nicor equalizes Sales and Customer Select storage allocations – reassigning storage currently allocated to the Hub or currently allocated to Sales – this is a step that should be taken to level the playing field between those two classes. It is Dominion's position that both Customer Select and Sales customers pay the same for Nicor's on-system storage; therefore, both should receive the same level of storage.

Dominion also states that it is Nicor's position that the rules proposed by Dominion should be rejected, not because of any deficiencies with those rules, but because they are based on rules used by Dominion East Ohio, an affiliate of Dominion. Dominion disputes Nicor's assertion that it would be preferable to address the proposed rules in a separate Illinois proceeding, rather than adopt the rules applicable to an Ohio LDC and its affiliate. In Dominion's view, Nicor fails to note that these rules have been in place for seven years in a utility with one half a million residential Customer Select customers representing 45% of its residential customers and 39,717 commercial industrial Customer Select customers representing an equal percentage of total industrial commercial customers. According to Dominion, this is an established, successful program in a Midwestern state. Dominion contends that there is no evidence that hose rules would not work in its service territory, or that it differs significantly from Dominion East Ohio, in any factor that could affect the rules.

Dominion claims that it and the other Customer Select suppliers who intervened as the RSG are active in many utility jurisdictions and have significantly more exposure than Nicor to LDC rules governing customer choice programs.

Commission Analysis and Conclusions

The Commission understands that the firm storage capacity allocations, including SBS entitlements, are currently determined by dividing Nicor's total amount of available storage by Nicor's peak day sendout. The result constitutes the firm storage or SBS entitlement for each customer or group of customers, currently 26 times MDCQ. Thus, as groups Sales customers, Customer Select customers and Transportation customers each are allocated an amount of firm storage equivalent to 26 times their group MDCQ. Those Transportation customers eligible for SBS service, as the Commission understands it, must subscribe to at least one times their MDCQ and are guaranteed up to 26 times their MDCQ. Additionally, these SBS customers can request an even higher SBS entitlement. Any firm storage that goes unsubscribed is provided to the Hub on an interruptible basis.

It is Nicor's position that in calculating the SBS entitlement, the Commission should use the same approach as was utilized in Nicor's last rate case. Under Nicor's calculation, the SBS entitlement would be reduced from 26 to 23 times a customer's MDCQ. Nicor claims that the numerator in the SBS entitlement calculation, the basis for most of the disagreement over this issue should be 120 Bcf, the amount of gas Nicor plans to cycle through storage in one year.

Staff recommends that the SBS entitlement must be increased from 26 times to 27 times the MDCQ entitlement. Staff's recommendation is based upon an analysis of historical data of averages for the coincident peak working gas in storage.

IIEC argues that in making the SBS entitlement calculation, the numerator should be 149.74 Bcf, which is the total amount of working gas in storage. IIEC's primary recommendation is that the Commission adopt an SBS entitlement of 28 times MDCQ. Like IIEC, RGS recommends using 149.7 Bcf in the numerator of the SBS entitlement calculation, yielding a result of 28 times MDCQ.

CNE objects to Nicor's proposal to reduce the SBS entitlement and supports IIEC proposal on this issue. CNE also objects to Dominion's proposed SBS entitlement which it avers that would have significant ramifications for Transportation customers.

Dominion's position is that currently, Customer Select customers are allocated too little storage relative to Sales customers. Dominion proposes a different method than the MDCQ approach for establishing the SBS entitlement for Customer Select customers. Dominion recommends that the Commission equalize the storage capacity of Sales customers and Customer Select customers by allocating sufficient storage to each class so that they can obtain the same amount of their annual requirements from storage. Dominion proposes using the highest most recent storage cycling amount, resulting in Sales service being allocated firm storage equal to 38.1% of its annual consumption and proposes Customer Select service be allocated firm storage equivalent to 38.1% of its annual consumption. Dominion makes no specific recommendation regarding the SBS allocation for Transportation customers.

As the Commission understands Dominion's proposal, the SBS entitlement for Transportation customers would remain the same and would presumably be determined on the basis of MDCQ. However, the SBS entitlement for Sales customers and Customer Select customers would be set at 38.1% of their annual consumption rather than based upon the MDCQ. The Commission has several concerns with this proposal. First, while Dominion claims that it creates equity between Sales customers and Customer Select customers, it appears likely to create disparity between these two groups of customers in relation to Transportation customers. Because Dominion did not make an explicit recommendation regarding the level of SBS entitlement for Transportation customers, it is impossible to know with certainty whether the results of its proposal would be fair to all customers. However, in the Commission's view, a proposal that uses different methods to establish the firm storage entitlements for different groups of customers is, on its face, questionable. The record simply does not support a finding that Dominion's proposal creates fair firm storage entitlements for all three groups of customers.

Dominion argues that the 149 Bcf working gas capacity is the correct amount of storage to be allocated among the three groups of customers. Again, however, because Dominion does not address the SBC entitlement of Transportation customers, it is not clear whether its proposal would result in 149 Bcf of storage being allocated among the three groups. This concern is exacerbated by the fact that Dominion's proposal relies on the premise that firm storage capacity can be reallocated to Customer Select customers from the Hub. Other than Dominion, however, no party suggests that Nicor actually allocates firm storage capacity to the Hub. Thus, it is possible that Dominion's proposal would result in more than 149 Bcf of storage capacity being allocated among the three groups of customers.

As noted above, Dominion asserts that Nicor currently allocates firm storage capacity to the Hub, that Nicor is giving away a portion of storage to the Hub, and that there is an improper diversion of an asset. Putting aside the disagreement regarding Nicor's total amount of available storage to be allocated, the Commission believes that current allocation process for firm storage is fair to all customers and does not need to be changed. Contrary to Dominion's assertion, the Commission does not agree that Nicor allocates firm storage capacity to the Hub. Instead, Nicor provides unsubscribed SBS capacity to the Hub on an interruptible basis. The Commission understands that if needed to meet the requirements of firm customers, any storage service provided to the Hub would be interrupted. The Commission disagrees that Nicor is giving away a portion of storage to the Hub or that there is an improper diversion of an asset. The issue of how Hub revenue should be allocated among the various customer groups is addressed elsewhere in this Order and the Commission rejects the argument that Nicor gives away firm storage service to the Hub.

As discussed elsewhere in this Order, the Commission believes there is a legitimate concern about the ability of Customer Select customers to utilize storage allocated to them. However, the Commission does not believe there is a significant problem with the basic manner in which firm storage is allocated among customers. The Commission finds that when viewed in their entirety, the conclusions regarding storage are fair and provide much of what Dominion seeks. For these reasons, the Commission rejects Dominion's proposal to change the allocation of firm storage capacity for Sales customers and Customer Select customers.

The Commission finds that the allocation of firm storage capacity, including SBS entitlements, should be based upon the MDCQ, similar to the method approved in Nicor's last rate case. The Commission observes that the calculation of SBS entitlement was not contested in Nicor's last rate case and the final order in that proceeding does not lay out exactly how the approved SBS entitlement was calculated. Thus, it is necessary to evaluate the arguments of the parties and determine the appropriate numerator to use in calculating the SBS entitlements.

Nicor's proposal appears to be based, at least in part, on a concern that if the SBS entitlement were based upon working gas capacity, Transportation customers might withdraw more gas than Nicor wishes because Nicor does not cycle all of its working gas in storage. As discussed subsequently in this order, however, Nicor also proposes to impose cycling targets on Transportation customers that would require Transportation customers to reduce the amount of gas in storage to 10% of capacity by April 1 of each year. Apparently, Nicor is concerned that in the absence of the cycling targets, Transportation customers will not withdraw as much gas as Nicor desires by the end of the winter heating season. In the Commission's view, Nicor has taken somewhat inconsistent positions with respect to Transportation customer's use of storage.

The Commission is convinced that the issue here is one of capacity allocation rather than some type of usage or volume allocation as Nicor's proposal could reasonably be characterized. As IIEC points out, a Transportation customer pays an SBS charge based upon a specific storage entitlement capacity subscription whether it reduces its storage gas volume to zero or not. The Commission believes that the SBS entitlement charge, by its very nature, is a capacity charge, not a usage or volumetric charge. In its reply brief, Nicor stated, "That 120 Bcf is the most accurate representation of the amount of gas that is going to be drawn out of storage in practice, not a theoretical capacity." (Nicor Reply Br. at 149). It would be inappropriate to base this capacity charge on the volume of gas that Nicor expects to be drawn out of storage. Instead, the capacity charge should be based upon the entire capacity of working gas in storage.

Additionally, the Commission finds it likely, as IIEC suggests, that Transportation customers, as a group, use less than the full amount of SBS entitlement to which they subscribe just as Nicor cycles less gas from storage than its total working gas inventory. Thus, to ensure that the SBS charge is calculated on the same basis as the nature of the service provided, the Commission concludes that the SBS entitlement calculations should utilize the entire capacity of the storage fields as the numerator. That is, the total capacity of working gas in storage should be used as the numerator.

Having determined that it is appropriate to utilize the capacity of working gas in storage in the SBS entitlement calculation, the Commission next turns to what that value is. Several parties believe the value is 149.74 Bcf, the total non-coincident storage capability of Nicor's storage fields, while Staff, based on an analysis of historical coincident peak working gas in storage, contends that the value is in the range of 139.60 Bcf to 143.37 Bcf. Nicor, in its Reply Brief, asserts that if the Commission decides to use the working gas in storage to establish SBS entitlements, Staff's proposed value should be revised to 132 Bcf because Nicor reclassified certain gas in storage.

SBS, as described by Nicor, "is a service offered to Transportation customers which allows them to serve all or part of their demands from supplies of gas that they have previously stored in Nicor Gas' storage fields." (Nicor Initial Br. at 122). In addition to supporting each of the above conclusions regarding SBS entitlements, we hold that Nicor's description of SBS establishes that the total non-coincident storage capability of Nicor's storage field should be used in establishing the SBS entitlements. Storage banking service encompasses the total amount of gas that customers place into storage or subscribe to place in storage, not the amount that they actually have in storage at any given point in time, the time of coincident peak gas in storage or otherwise. A portion of Nicor's total storage capacity is being allocated among a large group of diverse customers and, consistent with the other determinations made here, the Commission finds that non-coincident working gas in storage, 149.74 Bcf, is the amount of storage capacity that is being allocated. Due to customer diversity, Nicor's actual deliverability at any point in time, as well as its ability to meet deliverability requirements, should not determine the annual storage capacity entitlement of customers.

The Commission concludes that the SBS entitlement is set at 28 times the customer's MDCQ.

Storage Withdrawal Rights

<u>Nicor</u>

Nicor's proposed rates impose withdrawal limitations on an Operational Flow Order ("OFO") Shortage Day or Critical Day, for two reasons. First, Nicor states that its storage assets have a finite amount of withdrawals that can take place on any one day. Nicor argues that if it is to be able to serve all customers, it cannot allow unlimited storage withdrawals on a Critical Day or an OFO Shortage Day. Second, Nicor contends that Critical Days and OFO Shortage Days require careful planning and that large and unpredictable storage withdrawals by SBS customers could cause demand to exceed Nicor's physical maximum daily withdrawal capacity. Nicor also asserts that customers representing roughly one-third of Nicor's demand have no direct physical access to storage and are served directly from pipeline deliveries. Nicor argues that if these customers deliver no gas to the citygate and are not served from storage, rather than shut these customers off, Nicor must provide gas for these customers. According to Nicor, to serve all customers on an OFO Shortage Day or Critical Day without undue cost shifting, it is important that customer access to storage reflects Nicor's overall capabilities.

Nicor claims that using the same methodology as approved in its last rate case, Nicor updated the calculation using its current operating conditions and capabilities. Nicor proposes to decrease the cap on permitted withdrawals on a Critical Day or OFO

Shortage Day from 0.023 times the customer's selected SBS capacity to 0.021 times that capacity.

In its Reply Brief, Nicor states that its calculation is based on the amount of Nicor's planned peak day withdrawals that can be delivered from on-system storage, 2.5 Bcf. Nicor argues that Transportation customers should not be provided rights to storage withdrawals in excess of what can be withdrawn from storage to meet peak day, that is 47.5% (2.5 Bcf / 5.258 Bcf).

Nicor asserts that its proposed reduction merely reflects the fact that total peak day sendout has increased, while storage withdrawal capabilities have remained the same. In Nicor's view, CNE has not presented the Commission with any reasoned basis to depart from the methodology the Commission has approved in previous cases.

Also in its Reply Brief, Nicor states if Mr. Borden's compromise position of 132.525 Bcf is used to calculate 25 times MDCQ for SBS capacity, the withdrawal rights would be 1.9% of selected SBS capacity (2.5 Bcf / 132.525 Bcf). Nicor asserts that multiplying the 1.9% times 25 MDCQ days yields a withdrawal amount of 47.5 %, the same as the total Nicor system.

With respect to Dominion's proposal, which is discussed below, Nicor is willing to consider reasonable changes to Customer Select, so long as they (1) maintain a balance between the Transportation customers, Sales customers, and Customer Select customers, and (2) allow the program to expand without cost shifts among these customer classes. Nicor avers that it is willing to evaluate and discuss Dominion's proposals, but cannot say at this time that these two conditions will be satisfied.

IIEC

IIEC states that the current critical day withdrawal allowance is 2.3% of the customer's storage bank and in its filing, Nicor proposed to reduce that amount to 2.1%. IIEC indicates that Staff witness Mr. Borden accepted the Company figure of 2.1%. IIEC agrees with Mr. Borden, but only if the storage entitlement is set at the proper level of 28 days and not less than Mr. Borden's 27 days. IIEC avers that otherwise, reducing both the storage entitlement and the withdrawal would constitute a double penalty for Transportation customers.

RGS

As previously noted, RGS recommends that the Commission accept Nicor's proposal to reduce Customer Select Suppliers' critical day storage rights only if Customer Select and Transportation Suppliers' storage rights are maintained. RGS asserts that Nicor has failed to adequately justify either proposal, and reducing both would be a double penalty to Customer Select and Transportation suppliers.

RGS claims that Nicor did not refute the fact that Customer Select customers are not given the same storage withdrawal rights as Sales customers. RGS asserts that Customer Select customers do not have the ability, through their Suppliers, to access storage on a daily basis beyond the pre-determined base amounts (plus or minus the daily 10% tolerance, reduced by the proposed monthly 5% tolerance factor). RGS also claims that as the weather gets colder, Customer Select Suppliers are compelled to bring in greater and greater percentages of daily gas nominations from upstream assets, typically at higher prices, with a smaller and smaller percentage of daily consumption being accommodated with storage assets. RGS believes that the inequities that exist on the Nicor system can be ameliorated so that Select, Customer Sales, and Transportation customers are all provided with assets for which they pay.

RGS avers that as a compromise, it proposes that if the current level of 26 times MDCQ is maintained to determine storage rights for both Customer Select and Transportation, then RGS would be willing to accept the reduction from .023 to .021 as the factor to determine withdrawal rights on a critical day.

In its Reply Brief, RGS claims no one is proposing that Customer Select customers should have unlimited withdrawal rights or disputing that Critical Days and OFO Shortage Days require careful planning. Instead, RGS asserts that it, Dominion and others have presented evidence that Customer Select customers are not given even a fraction of the utilization rights enjoyed by Sales customers, and that as a result of their significantly diminished daily storage utilization rights, Customer Select and Transportation customers pay more for their gas than they would if storage equity existed between Sales, Customer Select, and Transportation customers.

CNE

According to CNE, Nicor's proposal to reduce a SBS customer's storage withdrawal right from 2.3% to 2.1% is magnified by Nicor's proposal to implement cycling requirements. CNE argues that if Nicor receives approval to implement cycling requirements, the Commission should not also simultaneously approve a reduction in storage withdrawal rights. CNE asserts that reducing storage withdrawal rights to 2.1% has roughly the same effect as missing the storage cycling fill-target by 10% even when no cycling requirements are in place. In CNE's view, to implement both a reduction in storage withdrawal rights and cycling requirements at the same time, compounds the adverse impact on customers, resulting in a more significant reduction to storage withdrawal rights for any customer that does not achieve target levels. CNE requests that the Commission reject Nicor's proposal to reduce a customer's SBS Storage withdrawal rights.

In its Reply Brief, CNE attempts to clarify its position on this issue. CNE states that it does not contend that the Commission should approve this reduction in storage withdrawal rights if Nicor is also allowed to implement cycling requirements. CNE argues that if cycling requirements are imposed on Transportation customers, and storage withdrawal rights are reduced to 0.021 times the customer's selected SBS capacity, the Transportation customer's ability to meet the cycling requirement's fill-target is made more difficult. If Nicor is allowed to implement cycling requirements, CNE requests that the Commission reject Nicor Gas' proposal to reduce a customer's SBS Storage withdrawal rights.

Dominion

Dominion asserts that Nicor's current withdrawal restrictions cost Dominion between $0.15 and $0.17 per decatherm, which is the range of cost to Dominion of purchasing a swing contract and interstate storage to manage the daily load swings. Dominion contends that these are duplicative services that Nicor's Sales customers are not required to purchase, because they have greater access to on-system storage capacity, even though Customer Select customers are paying for their pro rata share of the on-system capacity through their distribution rates. Dominion believes that requiring Customer Select customers to absorb that cost in their charges is anticompetitive and one of the primary reasons Nicor's Customer Select program has failed to meet its expectations.

Dominion states that it understands that maintaining functionality of Nicor's storage fields and balance among Sales, Transportation and Customer Select requires Nicor to have some control over the storage withdrawals of all three types of customers. Dominion claims that is why it proposed a comprehensive set of rules for storage service by Customer Select. Dominion states that these rules limit the amount of gas that can be withdrawn on normal and critical days and establish the levels of gas that must be delivered in order to meet daily delivery targets. Dominion avers that the Rules contain significant controls on injection and withdrawal to insure suppliers are managing their inventory appropriately and not gaming the system. Dominion asserts that Nicor has complete control if an OFO and when a critical day is declared, and that Nicor can require suppliers to deliver up to their MDQ on such days. Dominion claims these guidelines provide all Nicor's Sales customers and Customer Select customers with similar flexibility, while ensuring that Nicor's reliability is not impaired. According to Dominion, these rules are far more stringent than the Rules Nicor has in place for existing Transportation customers in terms of storage use and management.

Dominion asserts that the rules it proposed are based on the rules in place on the East Ohio Gas system in Ohio. Dominion claims the rules were developed in 1997 and revised in 2000 through a collaborative effort (Docket 96-1019-GA-ATA) between the company, the Public Utility Commission of Ohio and the interested parties. According to Dominion, the customer choice program in Ohio is more extensive than the one that Nicor operates. Dominion states that as of December 2004, 511,132 of the utility's 1,142,548 residential customers (45%) and 39,717 of its 85,969 commercial industrial customers (46%) were participating in the program. According to Dominion, East Ohio exceeds Nicor in both gross numbers and percentage of customers participating. Dominion contends that the utility is operating quite well with its Customer Select customers having storage usage rights similar to those of its Sales customers. Dominion it is not aware of any complaints by East Ohio Gas that these rules have placed its retail customers at a cost or reliability disadvantage relative to Customer Select customers.

Dominion disputes Nicor's assertion that the fact that delivery requirement is provided to the marketers by Nicor by 8:30 a.m., one day before the start of the gas day, provides Customer Select suppliers with flexibility because they have no obligation to manage shifts in customer load requirements after making the nominations for the next day.

According to Dominion, this locked in nomination is just as likely to be a detriment to Customer Select customers as a benefit because it is just as likely that weather the next day will be warmer than expected as it is that it will be colder than expected. If weather is unexpectedly warm, Dominion claims Nicor's procedures result in Customer Select customers bringing in more expensive winter gas than necessary.

Dominion contends that this argument ignores the fact that Nicor has created a different set of rules for Customer Select customers that are far more restrictive then the ones it has created for Transportation and Sales customers. Dominion states that while Transportation and Sales customers are able to avoid purchasing expensive gas on cold days by withdrawing more gas from storage, Customer Select customers must keep storage withdrawal constant and must instead purchase expensive gas to meet their needs. Dominion claims that the fact that Nicor gives Customer Select customers a 24 hour warning to make those costly purchases is not a particularly useful benefit.

Dominion claims this type of disadvantage is not necessary and has already been rejected by the Commission. Dominion states that in Docket 01-0740, the Commission rejected Peoples Gas Light and Coke Company's made a proposal to impose storage withdrawal requirements on its Rider SVT customers that were similar to those Nicor currently imposes on Customer Select customers. In Dominion's view, if the Commission desires true parity between Customer Select and Sales customers, it should accept the proposal of Dominion to give each the same type of flexibility.

Dominion also objects to what it describes as Nicor's recommendation that the Commission do nothing now and instead open another proceeding to investigate potential changes to the Customer Select program. Dominion argues that the Commission has been presented with evidence that Nicor's storage withdrawal rules are discriminatory, anticompetitive and unnecessary. Changes should therefore be made now, rather than later.

Dominion contends that Nicor's concern about the participation of more Customer Select suppliers is not an issue, because subsequent to the filing of Nicor's testimony, Direct Energy Services, LLC, Interstate Gas Supply of Illinois, MidAmerican Energy Company, U.S. Energy Savings Corporation and WPS Energy Services (collectively known as "Retail Gas Suppliers"or "RGS") intervened in this proceeding and sponsored the testimony of Mr. Scott White. Dominion avers that Mr. White supported Dominion's proposals. Dominion argues that between it and the Retail Gas Suppliers, the Commission has before it a broad representation of Customer Select suppliers that are requesting a change now – not at some future date. Dominion argues that few if any Customer Select suppliers would object to Dominion's proposals to give them more flexibility in storage withdrawals.

Dominion recommends that the Commission reject Nicor's gambit to put off a decision on appropriate storage withdrawal rules until some future date. Dominion claims that Nicor has no problem with a rate case being the appropriate forum to address Nicor's proposed changes to the Customer Select program, such as changes in the month-end tolerance or allowed on system gas storage levels. Dominion adds that Nicor did not feel the need to enter into a collaborative process with Customer Select suppliers when developing the proposals it made in this proceeding. Dominion contends that the nature of its proposals are no different and should have the same right to a hearing and decision as Nicor's proposals.

Commission Analysis and Conclusions

Nicor proposes to reduce the OFO Shortage Day or Critical Day withdrawal limit from 0.023 times the customer's SBS capacity to 0.021 times the SBS. IIEC does not object to Nicor's proposal provided the Commission increase the SBS entitlement to either 27 or 28 times the MDCQ. Similarly, RGS does not object to Nicor's proposal provided that the SBS entitlement is not reduced below 26 times the MDCQ. It is CNE's position that the Commission should not reduce SBS storage withdrawal rights if Nicor is allowed to impose its proposed cycling requirements.

As discussed above, Dominion has proposed an entirely different set of rules for storage service that would apply to Customer Select customers. Dominion claims that its proposal is superior to Nicor's existing and proposed tariffs and rules.

The Commission has previously reviewed and found Nicor's existing Customer Select tariffs and rules to be just and reasonable. While the Commission is willing to consider specific proposed changes and improvements to Nicor's existing rules and tariffs, at this time, the Commission is not prepared to simply abandon Nicor's existing tariffs and rules in favor of a set of rules adopted by the Public Utility Commission of Ohio. The record of this proceeding simply does not support a conclusion that Nicor's existing tariffs are so flawed that they must be abandoned. There has been no showing that Customer Select suppliers do not manage their inventory appropriately or are gaming the system, the bases Dominion offers for adopting its proposed rules.

Finally, in the event Dominion's proposed rules were adopted for Customer Select customers, it is not clear whether it expects the rules to be applied to Transportation customers. If not, this raises significant fairness issues between the two groups of customers. If so, the Commission simply observes that no other party supports Dominion's proposal.

It appears to the Commission that IIEC, RGS and CNE acknowledge that for operation purposes, OFO Shortage Day and Critical Day SBS withdrawal limits are necessary. The Commission believes the primary concerns of these parties actually relate to other storage management issues such as SBS entitlements and storage cycling requirements. These issues are addressed elsewhere in this Order and the Commission believes that when viewed in their entirety, these decisions provide Transportation customers and Customer Select customers with sufficient flexibility to effectively manage their storage, while still providing Nicor with sufficient control of its storage assets in an efficient and cost effective manner. As a result, the Commission hereby approves Nicor's proposal to reduce the OFO Shortage Day and Critical Day SBS withdrawal limit from 0.023 times to 0.021 the customer's SBS capacity.

Issues Specific to Rates 74, 76, and 77 – Firm Transportation Service

Maximum Daily Nomination

Nicor

Nicor proposes that maximum daily nominations by Transportation customers during the heating season should be reduced from twice the customer's MDCQ to simply the customer's MDCQ. According to Nicor, the daily nomination is the amount of gas a Transportation customer can deliver to Nicor's system to be used by the customer or added to its storage balance. Nicor claims it is proposing this change because winter injections run counter to Nicor's overall objectives to cycle its fields.

Nicor argues that allowing Transportation customers to nominate their entire MDCQ during the winter continues to provide sufficient flexibility for customers. Nicor states that the MDCQ is not the average daily use, but the maximum volume a customer is expected to use on a single day in the year. In Nicor's view, since a customer is not using its MDCQ every day, all Transportation customers will have the flexibility to do some re-injection into storage in the winter. Nicor contends that this is more flexibility than Nicor's system actually has: the system equivalent of all customers' MDCQ is its worst case "design day," and Nicor cannot actually inject its full design day amount of gas on any day of the year, let alone a day in the withdrawal season.

Nicor contends that, based on its experience running the storage fields, its proposed limits will not reduce gas deliveries to the system on cold days when Nicor needs it most. Nicor asserts that when cold weather occurs or is forecast, prices begin going up, and customers reduce their deliveries and do not pursue additional purchases of high-priced gas. Nicor avers that since the limit is set at the maximum daily usage, not average use or actual use, some re-injection will be possible. Nicor disagrees with the suggestion that its proposal will prevent winter injections.

Nicor also disagrees with RGS witness Mr. White that its proposal discriminates against Transportation customers because Nicor injects gas into storage during the winter to restore performance. Nicor claims that storage fields cannot perform at peak withdrawal rates continuously. Nicor states that withdrawals at high rates impact subsequent days and Nicor may need to re-inject gas to be able to meet demand for all customers, including Transportation customers. Nicor contends that Transportation customers need not be concerned with operational performance of Nicor's fields, and their daily withdrawal rights remain the same regardless of the decline in the actual withdrawal capabilities as inventory is withdrawn. Nicor maintains that Transportation customers will have significant flexibility to re-inject gas during the withdrawal season.

In its Reply Brief, Nicor argues that it does not typically get much help with injections from Transportation customers when the weather really gets cold, because the price of gas, which follows the law of supply and demand, increases due to increased demand and Transportation customers therefore have an incentive to reduce purchases and make storage withdrawals rather than injections during these periods.

In response to RGS, Nicor claims its proposed change is not intended to cure a potential failure of the system. Nicor contends it is attempting to limit winter injections consistent with its operational need to cycle the gas fields. Additionally, Nicor avers that IIEC is correct that such customers would not be able to inject much gas during the winter, and would need to build up their storage balance prior to the beginning of the heating season. Nicor claims this is consistent with its overall objective.

Nicor maintains that it provides substantial flexibility for winter deliveries by Transportation customers. According to Nicor, Transportation customers' MDCQ is established at the higher of their highest one day use of gas or their expected use of gas on a worst case design day (79 HDD). Nicor argues that there are not many customers, if any, who use gas every day as if it were 14 degrees below zero all winter long. Nicor states that Transportation customers can re-inject into storage the difference between their use on a day and their MDCQ, which Nicor claims is significant on any day warmer than zero degrees.

Staff

Staff believes Nicor has provided sufficient justification to warrant the reduction in daily nominations. Staff recommends that Nicor's proposal to reduce daily nominations for Transportation customers from twice the MDCQ to just the MDCQ be accepted by the Commission.

IIEC

According to IIEC, currently, Transportation customers may nominate up to two times their MDCQ so a customer who uses close to its MDCQ may nominate additional gas to be credited to its storage account. In IIEC's view, this is reasonable. IIEC asserts that there is no evidence that the current practice has caused any concerns for Nicor or has adverse consequences for the system.

IIEC states that Nicor can nominate more gas on a day than its customers use because, without this ability, it could not make any injections into storage. It is IIEC's position that the same logic should apply to Transportation customers. IIEC urges the Commission to accept its recommendation that the current parameters remain unchanged.

IIEC also disputes Nicor's assertion that even under Nicor's proposal, customers will have the ability to inject gas into storage in winter because the MDCQ is not an average daily use but a maximum volume a customer is expected to use on a single day. According to IIEC, Nicor overlooks the fact that many Transportation customers have higher load factors and will use close to their MDCQ on most days. IIEC contends that it would be difficult, if not almost impossible, for such customers to store gas in the winter months if Nicor's proposal were adopted.

IIEC claims Nicor's proposal would have the effect of reducing gas flows in the winter months, when gas use is highest. IIEC argues that this could actually harm Sales customers because gas prices are generally higher in the November 1 to March 1 time period, and high daily nominations by the Transportation customers could help displace more costly gas purchases by Nicor. It is IIEC's position that gas flows in the winter should be encouraged, not discouraged, as they would be under the Nicor proposal to reduce the daily nominations for Transportation customers. IIEC asserts that because Nicor's proposal will be detrimental to Sales and Transportation customers, it should be rejected.

CNE

CNE asserts that Nicor has failed to provide any empirical evidence that substantiates the need to reduce a customer's maximum daily nomination annually from 2 to 1 times the MDCQ from November 1 through March 31. CNE contends that Nicor did not demonstrate that any harm accrues to Sales customer through retaining the current limit of 2 times the MDCQ. According to CNE, Nicor's proposal could actually harm Sales customers, since during this time period gas prices are often higher than during the rest of the year. CNE claims that higher nominations from November through March could actually serve to displace more costly gas purchases by Nicor.

CNE requests that the Commission reject Nicor's proposal to reduce a customer's maximum daily nomination.

Vanguard

Vanguard maintains that maximum daily nominations should not be reduced from two times MDCQ to one times MDCQ during the period November 1 through March 31. Vanguard asserts that reducing the maximum nomination of marketers into Nicor's system during the winter puts more of a burden on the utility to purchase gas when the demands of the system increase, typically due to colder weather. Vanguard claims that during the winter season, demands on Nicor's distribution system are increased due to cold weather by both Sales customers and Transportation customers alike. Vanguard states that natural gas prices in the Chicago market typically rise when the weather gets colder, thus reducing the MDCQ for Transportation customers could have a negative impact on Sales customers' gas commodity price because Nicor will be forced to buy additional gas at higher prices to maintain system reliability.

According to Vanguard, Nicor and the marketing community currently work in concert with one another to maintain system integrity across Nicor's distribution system. Nicor's tariff states: "Nicor will first request customers and suppliers to voluntarily take actions to alleviate the supply situation that is threatening operational integrity, to the extent possible." Vanguard claims that during severe cold weather, Nicor has issued Advisory Notices in accordance with Gas Sheet No. 48, encouraging marketers to increase deliveries.

Vanguard further claims that if voluntary measures pursuant to these notices do not alleviate the supply situation, Nicor then has the responsibility to call an OFO or possibly even a Critical Day. Vanguard emphasizes that during a Critical Day, the marketing community for Transportation customers and Nicor's supply department work in tandem to maintain the reliability of Nicor's distribution system. Vanguard contends that failure to do so on the part of the marketer results in substantial monetary penalties, such as an Unauthorized Use Charge.

It is Vanguard's position that the current working environment between Nicor and marketers and the current MDCQ enables marketers to assist Nicor during Advisory Notices and on Critical Days. Vanguard argues that if the current MDCQ is reduced, marketers will no longer be able to effectively assist Nicor when a supply situation threatens operational integrity.

RGS

RGS states that Nicor ignores consumption when reducing the maximum daily nominated gas quantity for Transportation customers during the winter season from 2 times MDCQ to 1 times MDCQ. RGS asserts that given the time of year the restriction exists, it is likely that on most days a portion, if not the entire delivered amount of gas, will be used for daily consumption, leaving little or nothing to inject.

RGS states that Nicor will, at times, inject gas during the winter to restore storage performance after periods of high withdrawal. RGS argues that for the same reasons, and to ensure that Transportation customers will have sufficient storage gas remaining for the entire winter season, transporters may also need to inject gas into storage after periods of higher withdrawals. RGS claims Nicor's current proposal does not permit Transportation customers to make these injections, since consumption will reduce any amounts nominated.

According to RGS, industrial customers that transport and use a significant amount of their gas for production are not as affected by weather related events and need to be sure that they can fully utilize their allotment of storage according to various fluctuations in the market and usage patterns. RGS asserts that for industrial customers, the MDCQ may be at or below the actual consumption on a daily basis, once withdrawals have occurred for the November 1 through March 31 period.

In RGS' view, it will be difficult, if not impossible, to replenish storage at sufficient levels to mitigate against various price fluctuations. RGS contends that since the MDCQ is not often an accurate estimation of the peak day usage, setting the maximum amount that a Transportation customer can bring onto the system during the five-month period at the MDCQ underestimates the volumes that are needed to serve the class as a whole. RGS believes that usage must be taken into consideration when determining limits placed on gas nominations, in conjunction with system constraints.

RGS suggests although Nicor has failed to demonstrate that a change is necessary, in the event the Commission determines that a reduction is necessary, the reduction should not be to 1 times MDCQ. In RGS' view, it would be appropriate for the Commission to adopt a compromise position: permitting Transportation customers to nominate up to 1.5 times MDCQ on a daily basis during the five-month winter period.

In its Reply Brief, RGS claims that the flexibility Nicor cites in the MDCQ is not applicable to all customers, and Nicor's proposed reduction would have a significant impact on many customers, especially those with flat loads. RGS claims that storage utilization includes the ability to refill storage at various stages throughout the season. RGS states that similar to Nicor, Transportation customers (1) deplete storage to varying degrees during peak periods; (2) need to be able to bring additional gas back into storage during non-peak periods; (3) need to prepare for subsequent peak periods; and (4) should be permitted to take advantage of periodic dips in the natural gas market. In RGS' view, Nicor should not be permitted to ignore consumption, reduce the maximum daily nominated gas quantity for Transportation customers during the winter season from 2 times MDCQ to 1 times MDCQ, or unreasonably reduce injections November 1 through March 31.

RGS further argues that since injections will only occur after consumption volumes are deducted each day, the limitations are on delivery and not injection, and the first volumes nominated through the pipes each day will be used by Nicor to satisfy daily consumption, it would not be possible to inject a full MDCQ on any given day. RGS claims that any amount of gas remaining after the consumption amount has been satisfied, could then be injected. RGS asserts that given than Nicor has imposed a time-of-year restriction, it is likely that on most days a portion, if not the entire delivered amount of gas, will be used for daily consumption, leaving little or nothing to inject.

Commission Analysis and Conclusions

Currently, Transportation customers can nominate up to two times their MDCQ. Nicor proposes to reduce that to one times the customer's MDCQ during the winter season. Staff supports Nicor's proposal while IIEC, CNE, Vanguard and RGS oppose it.

The Commission rejects Nicor's proposed change. To the extent possible, the Commission would prefer to increase rather than reduce the flexibility of customers, whether Transportation customers or Customer Select customers. Nicor has been operating under the existing maximum daily nomination for many years. While the Commission can understand Nicor's argument that storage injections in winter are inconsistent with Nicor's objectives to fully cycle its storage fields, winter injections also seem fully consistent with Nicor's objective of maintaining sufficient gas in storage to meet late winter demands for significant storage withdrawals.

The record contains no analysis that demonstrates Transportation customers intentionally interfere with Nicor's efforts to cycle its storage fields or that the activities of Transportation customers have ever actually interfered with Nicor's efforts to cycle its storage fields. In the absence of additional empirical evidence or a more compelling argument, the Commission has no choice but to reject Nicor's proposed change.

Intraday Nominations

Nicor

CNE proposed that Nicor be required to include in its tariffs additional intraday nomination cycles. As an initial matter, Nicor claims that CNE's proposal is not relevant to any rate sheet that Nicor has proposed to amend, so there are no tariff sheets currently suspended and before the Commission for decision on this issue. In Nicor's view, it is not appropriate to consider CNE's suggestion, absent proof that Nicor's currently filed tariff is unjust and unreasonable. Nicor states that CNE has not suggested any tariff language for the Commission to adopt and claims that adopting such a proposal is not practical until Nicor has in place the systems that would be necessary to implement such a proposal. Nicor contends that CNE has not met its burden to show that Nicor's current tariffs, which do not permit intraday nominations other than on an OFO Shortage Day or Critical Day, are unjust and unreasonable. Nicor argues that taken as a whole, Nicor's nomination tariffs are appropriate and reasonable.

Nicor also asserts that the North American Energy Standards Board (NAESB) guidelines are written for, and applicable to, interstate pipeline transactions, not local distribution companies. Nicor claims it does follow the NAESB standards to the extent required for the efficient coordination with interstate pipelines or gas suppliers. Nicor avers that it is under no obligation, by regulation or by the NAESB standards themselves, to operate under all their provisions.

According to Nicor, in judging tariffs, one needs to look at the rules of a utility as a whole, because each tariff has numerous provisions, and some provisions may be favorable in one area and other provisions may be less favorable. Nicor argues that the actual tariffs of one of the utilities that currently provides intraday nominations revealed that the utility requires suppliers to match deliveries on a daily basis, making intraday nomination more appropriate.

Additionally, Nicor claims it does allow the intraday amendment of nominations at the only time it would likely be of significant use to a marketer: during a Critical Day or OFO Shortage Day, including over a weekend. Nicor argues that customers served under Nicor's tariffs have little reason to need to change a nomination over the course of a single day, absent severe weather. Nicor contends that under other conditions, when NAESB type nominations are not available, an unexpected increase or decrease in customer usage would simply be met by Nicor out of the customer's storage on a real-time, no-notice basis. It is Nicor's position that there is no real need for intraday nominations on Nicor's system.

In its Reply Brief, Nicor argues that intraday nominations would only make sense in the overall context of Nicor's tariffs, if other features of the tariffs were different. Nicor claims that if it required suppliers to match deliveries on a daily basis, intraday nominations would be appropriate. Nicor suggests that if its tariffs shared some of the special restrictions of the interstate pipeline tariffs, intraday nominations would be appropriate, but that is not the case here. Nicor claims that on its system, there would not be much need for an intraday nomination, except perhaps on an exceptionally cold day. Nicor adds that on OFO Shortage Days and Critical Days, Nicor already permits intraday nominations, even on weekends.

Finally, Nicor argues that not only are intraday nominations not needed on its system, but that they would require extra computer systems that Nicor does not presently have.

CNE

CNE proposed that Nicor be required to include in its tariffs intraday nomination cycles, specifically: the Evening Cycle, Intraday 1 and Intraday 2 cycles, along with the Timely Cycle which Nicor currently accepts. CNE claims that the additional intraday nomination cycles would provide Transportation customers with the ability to change nominations when necessary after the Timely Cycle deadline has passed. CNE avers that the need to adjust nominations can arise for numerous unexpected reasons, including weather conditions, changes in a customer's production schedules, or due to a pipeline or utility system disruption. CNE states that it provided suggested tariff language for intraday nominations. CNE contends that this ability would be similar to what Nicor's own internal supply operations personnel can do, who use this capability to help maintain supply stability. CNE suggests that Transportation customers deserve the same option for the same reason – to help customers manage their load requirements when unanticipated changes occur.

According to CNE, intraday nominations are the industry standard. CNE claims that the NAESB and its predecessor, the Gas Industry Standards Board, have developed various standards to ensure smooth and efficient operations between producers, pipelines, local distribution utilities, marketers, and others. CNE avers that NAESB is the industry forum for the development and promotion of standards which will lead to a seamless marketplace, and its process for development and implementation of standards is consensus driven.

CNE argues that it is not asking Nicor to do something that other Illinois gas utilities have not already done. CNE asserts that over 26 other gas utilities in the upper Midwest region contiguous to the state of Illinois have implemented the use of intraday nominations, including Illinois utilities such as MidAmerican Energy Company; Peoples Gas Light and Coke Company; and AmerenIP.

CNE disputes Nicor's assertion that allowing intraday nominations for Transportation customers would increase uncertainty in its system operations and increase costs. CNE argues that it is doubtful that 26 other gas utilities would implement the use of intraday nominations if it threatened the safe and reliable operation of their systems. CNE further contends it is doubtful that those same 26 other gas utilities would allow intraday nominations if the direct result was an increase in costs. CNE also avers that the Commission would not have approved intraday nominations for AmerenIP, or for other regulated utilities in Illinois, if system operations would have been compromised.

CNE claims that Nicor's existing tariffs contain at least four provisions that independently control the manner and extent to which Transportation customers deliver gas into the Nicor system that would render any assertions regarding threats to safe and reliable operation of Nicor's system moot. First, to assist Nicor in monitoring a customer's deliveries and usage, a Transportation customer on Rates 74, 76, or 77 must have a telephone line installed and Nicor also installs a daily usage recording device. Second, Transportation customers are required to establish a MDCQ of natural gas which remains effective for a 12-month billing period. CNE avers that Nicor can refuse to allow a Transportation customer an MDCQ that it believes is unreasonably high. Third, Nicor is not obligated to accept a Transportation customer's gas when nominations do not comply with Nicor's tariff procedures, and Nicor controls the order of deliveries of gas into its system. Fourth, Nicor determines a customer's authorized and unauthorized use levels, and can terminate a customer with one-hour's notice if an unauthorized use level interferes with Nicor's operations of its system.

According to CNE, while Nicor currently only accepts the Timely Cycle nomination, Nicor does so electronically through its Electronic Nomination System available on Nicor's website at Gas Exchange. CNE claims that other utilities that currently allow intraday nominations in conjunction with the Timely Cycle nomination typically incorporate additional windows on their electronic bulletin board to accept intraday nominations; some make pre-arranged schedules with Transportation customers and marketers in which utility personnel "let the customer/marketer back into" their electronic system to make the subsequent intraday nomination. CNE argues that in either case, if additional costs are incurred by Nicor to accommodate intraday nominations, Transportation customers and marketers would expect such costs to be recovered through transportation-related charges. CNE claims there is no need for non-Transportation customers to pay for the cost of a service not providing such customers any benefit.

CNE disputes Nicor's assertion that there are presently no tariff sheets before the Commission on this issue. CNE states that since Nicor failed to present any such tariff sheets to the Commission, CNE entered proposed tariff language into the record.

According to CNE, while Nicor may be "technically" correct that the NAESB guidelines regarding intraday nominations are only applicable to interstate pipelines, not local distribution companies, Nicor ignores the fact that no less than 28 local gas distribution utilities in the Midwest alone and many others throughout the United States do allow intraday nominations and have modeled their provisions on the NAESB guidelines.

In response to Nicor's assertion that only weather-related conditions produce a need to change nominations during the course of a single day, CNE claims that commercial and industrial Transportation customers live in include changes in a customer's production schedule or service disruptions by the pipeline or utility can require adjustments in deliveries.

It is CNE's position that Transportation customers on the Nicor system deserve the same option that customers have on other Illinois gas utility systems, and most other gas utilities in the U.S. According to CNE, customers should have the same ability that Nicor's own internal supply operations personnel have, who use this capability to help maintain Nicor's supply stability. CNE argues that Nicor Transportation customers have the same need to manage their load requirements when unanticipated changes occur.

Commission Analysis and Conclusions

Currently, Nicor's tariffs do not permit intraday nominations other than on an OFO Shortage Day or Critical Day. CNE recommended that Nicor be required to include in its tariffs intraday nomination cycles: the Evening Cycle, Intraday 1 and Intraday 2 cycles. Nicor objects to CNE's proposal.

As Nicor points out, Transportation customers and suppliers have made several proposals in this proceeding aimed at increasing their flexibility in using storage and the request for intraday nominations could be considered one of these. In the Commission's view, many of these storage issues are interrelated and the Commission faces the difficult task of providing Transportation customers a reasonable amount of flexibility while also providing Nicor with sufficient control of its gas system to ensure total supply equals total demand at a reasonable cost.

As the Commission understands it, SBS functions to some extent as a balancing service. A Transportation customer supplier makes its nomination for the following day based upon its anticipated usage. Additionally, the Transportation customer supplier can nominate the use of Nicor owned storage under its SBS arrangement. The Transportation customer's supplier delivers gas to Nicor's citygate consistent with the nomination. Nicor has responsibility for meeting the daily system-wide demand using all resources available while managing cost. If a Transportation customer actually uses more gas than anticipated, its SBS account is debited for the shortfall and if it uses less gas than anticipated, its SBS account is credit for the excess. It is the Commission's understanding that the daily tolerance provisions contained in Nicor's tariffs allow for the possibility that the amount of gas actually delivered to the Nicor citygate will vary from the amount nominated by the Transportation customer.

While the Commission believes that Nicor should provide customers and suppliers as much flexibility as is reasonably possible, the Commission rejects CNE's proposal at this time. The Commission is concerned that providing intraday nomination flexibility to customers will make it more difficult for Nicor to operate the gas distribution system. Allowing additional intraday nominations for Transportation customers could strain Nicor's ability to manage its pipeline supplies, swing contracts and storage fields. Nicor has expressed concern about its ability to fully cycle its storage fields and the Commission believes CNE's intraday nomination proposal could exacerbate that problem.

Transportation customers have sufficient flexibility to manage their supply resources without requiring Nicor to offer intraday nominations. Similarly, the Commission has provided Nicor enough control over the gas system to meet all its customers obligations. The Commission makes no conclusion whether it may be appropriate to require Nicor to offer additional intraday nomination options to Transportation customers at some future point in time.

SBS Charge

<u>Nicor</u>

According to Nicor, Transportation customers may select, within limits, a level of Storage Banking Service, and pay a separate charge for that service. Nicor derives the SBS charge by taking the cost of storage, as developed by its ECOSS, subtracting the cost related to top gas, since Transportation customers supply their own gas, and dividing by the amount of gas that Nicor expects to cycle in a season. Nicor's calculation results in an SBS charge of $0.0038 per therm.

Nicor avers that the only issue is selecting the correct numerator and denominator in the calculation. According to Nicor, IIEC argues that Nicor should have credited Hub revenues to the cost number in the numerator. Nicor claims IIEC is incorrect for the same reasons. It disputes IIEC's position with respect to the Allocation of Hub expenses through the revenue requirement. Nicor's arguments on this issue are contained elsewhere in this Order and are not repeated here.

Nicor avers that IIEC also claims that Nicor should have used, rather than the 120 Bcf figure for expected gas cycled, total non-coincident maximum top gas. Nicor's rational for using 120 Bcf and its arguments regarding IIEC's proposal are the same as those previously stated elsewhere in this Order in the section relating to Storage Capacity Allocation.

Nicor states that Staff witness Mr. Luth calculated the SBS charge using the same methodology as Nicor, although he used different numbers. Nicor avers that Mr. Luth used Staff's calculation of storage costs, but did not use Staff's calculation of cycled gas. Nicor asserts that if he had, his calculated SBS storage charge would have matched Nicor's.

Nicor opposes CNE's proposal that would allow Transportation customers to sell gas withdrawn from storage to any other end users or marketers. Nicor argues that customers who have too much gas in storage can reduce or sell their flowing gas just as Nicor would. Nicor contends that providing this service would, in effect, make Nicor the "back office" for gas sales transactions and would increase costs that should be borne by the Transportation customers. Nicor claims, however, that the record does not establish what those costs would be, as this suggestion did not surface until CNE's rebuttal testimony.

Staff

According to Staff, it and Nicor are in basic agreement concerning the calculation of the SBS charge. Staff avers that when the Commission determines the base amount of cycled test year storage gas, the calculation of the SBS will be straight-forward.

Staff indicates that its calculation of the SBS should be adjusted to allocate the cost associated with the 2% storage withdrawal factor to Sales customers only. Staff avers that cross-examination of Staff witness Luth showed that the 2% storage withdrawal factor is included in the calculation of the SBS, but did not show that the 2% storage withdrawal factor was included in cost of service for Transportation customers. (Tr. 1284-1288) Staff states that since the SBS is applied only to Transportation customers, for proper separation of billing elements to Transportation customers, the storage revenue requirement should be reduced by the amount of the adjustment included in revenue requirement.

Staff recommends that the Commission reject IIEC's proposed lower SBS Charge 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.

IIEC

IIEC states that the SBS charge is the unit charge per Mcf of maximum storage capacity that Transportation customers must pay. IIEC supports a charge of $0.00215 per therm per month. IIEC emphasizes that Transportation customers who elect storage pay this charge on the total amount of capacity that they reserve, regardless of the amount of gas that they keep in storage, put into storage or take out of storage. IIEC avers that all parties agree that the first step in developing the SBS charge is to take the embedded cost of storage, excluding the cost of top gas, and divide it by a denominator. IIEC avers that there is also no question that the relevant embedded cost of storage to use for this purpose is $53,593,000 before any credit given for net profit from Hub services.

IIEC rejects Nicor's proposal to use 120 Bcf as the denominator because that is the volume that Nicor expects to cycle in and out of storage. It is IIEC's position that the denominator has to be the full working gas capacity of the system. IIEC's reasons for using working gas as the denominator are the same as those articulated elsewhere in this Order in the Section relating to Storage Capacity Allocation.

If the Commission is persuaded to adopt Mr. Borden's working gas capacity of approximately 141 Bcf as appropriate for Storage Capacity Allocation, IIEC acknowledges it would be reasonable to use that same figure as the denominator for purposes of calculating the SBS charge. IIEC states that Staff witness Mr. Luth agreed to this principle but did not reflect the 141 Bcf in his proposed SBS charge. IIEC avers that Mr. Luth's recommended charge should be rejected or modified if the Commission adopts the recommendation of Staff witness Borden and IIEC witness Rosenberg.

IIEC also proposed a further adjustment in the calculation of the SBS charge. IIEC witness Dr. Rosenberg summed the injections for each year for the last four years and the withdrawals for each year for the last four years. He then took the maximum of those two sums and compared them to the SBS capacity that the Transportation customers had elected. He developed an average ratio of 80%. In IIEC's view, this suggests that Transportation customers used 80% of the storage that they paid for. IIEC claims this phenomenon is not disputed by Nicor, nor is there any evidence that this historic pattern of underutilization will not continue in the future. IIEC argues that it is proper and reasonable to reduce the quotient described above by 20% to account for the fact that Nicor does not have to supply the full amount of storage nominated by the Transportation customers.

In its Reply Brief, IIEC complains that Nicor failed to address IIEC's recommendation that the SBS charge also be adjusted to reflect the fact that Transportation customers do not cycle the full amount of gas they bank with Nicor. IIEC states that Nicor did assert that using the marginal cost of storage service as a pricing guide would undervalue the service being offered to Transportation customers, however, its proposed storage charge is based on an embedded cost analysis and is above marginal cost. Therefore, IIEC concludes that Nicor's assertion is not relevant to IIEC's proposed rate design.

IIEC also argues that Nicor's assertion that its proposed SBS charge calculation yields a charge that would be paid to an interstate pipeline to obtain equivalent day deliveries is without merit. IIEC asserts that the cost of obtaining interstate pipeline capacity is not relevant to determining the cost of service on the Nicor system.

IIEC maintains that it is entirely appropriate to reflect the reduced usage level in the calculation of the SBS charge. In addition, IIEC contends that its proposal is based on cost of service principles. In IIEC's view, if Transportation customers in the aggregate reserve 40 Bcf of gas, Nicor does not have to reserve 40 Bcf of storage capacity in order to provide the service, but something considerably less than 40 Bcf. IIEC avers that this is because of customer diversity, and the fact that Transportation customers will not use their full storage allowance in order to avoid penalties.

According to IIEC, if Hub revenues are credited back to Transportation customers through the PGA as recommended by Staff, there would be no need to credit Hub revenues against the embedded storage costs used in the numerator of the SBS charge. Under this scenario, the IIEC state that its proposed SBS charge would be somewhat higher than the charge originally calculated by Dr. Rosenberg, $0.00045 higher if Nicor's denominator is used and $0.00035 higher if IIEC's denominator is used.

Also in its Reply Brief, IIEC states that Staff recognized an error in its calculation of the SBS charge and has agreed to correct it. While IIEC urges the Commission to reject the Staff's proposed ECOSS, if the Staff's cost study is accepted, IIEC agrees that Staff's proposed adjustment to the demand charge would be necessary to reflect the removal of the 2% storage withdrawal factor from the calculation of the SBS charge.

CNE

CNE states that the current rate for Nicor's SBS is $0.0039 and Nicor proposed to slightly decrease the rate for SBS to $0.0038. CNE also states that in direct testimony, Staff supported this rate of $0.0038; however in rebuttal testimony, Staff Witness Luth suggested that the rate for SBS be increased by 15% to $0.0045. According to CNE, Staff's revised proposal is in error as it incorrectly allocates costs to Transportation customers that should not be allocated to them.

CNE states that Transportation customers currently are restricted by Nicor so that they can only sell their gas in storage to other end users within the same group. CNE argues that Nicor should be required to remove this restriction so that SBS customers are able to sell gas withdrawn from their storage account to other end users or marketers. CNE contends that SBS customers should be afforded the flexibility to buy or sell gas from other storage holders or to sell their excess gas supply to other marketers, increasing the competitiveness of the Nicor market. CNE asserts that Nicor did not present any evidence to support a finding that such a proposal would harm Sales customers.

According to CNE, removing rules that restrict customers' ability to sell gas withdrawn from their storage account becomes even more important, if Nicor imposes target levels for storage injections and withdrawals. CNE argues that such added flexibility will provide this group of customers with a tool that will assist them in achieving the target levels that Nicor will require by removing a restriction that currently limits their ability to cycle gas volumes.

Commission Analysis and Conclusions

The calculation of the SBS charge depends largely on decisions made with respect to related issues. The tariffs filed by Nicor, after the conclusion of this proceeding, should include an SBS charge that reflects the Commission's decision regarding the embedded cost of service less the cost of top gas, divided by the working gas in storage, 149.74 Bcf, a portion of which is allocated to Transportation customers consistent with the decision above regarding "Storage Capacity Allocation." The tariffs filed by Nicor should also reflect the Commission's decisions above regarding the proper allocation of Hub revenues.

Finally, the Commission rejects IIEC's recommendation that the SBS charge be reduced to reflect the fact that Transportation customers historically have not fully utilized the storage to which they subscribe. As discussed above, the SBS charge is a capacity charge, not a volume or usage charge. The decision regarding storage capacity allocation above was premised on the fact that the SBS charge is a capacity charge. IIEC cannot have it both ways – have the amount of storage Transportation customers allocated based upon a capacity argument and also have the associated storage charge reduced based on a volume or usage argument.

In the Commission's view, IIEC has identified the possibility that Transportation customers tend to subscribe to greater levels of SBS than required. The Commission does not believe that lowering the SBS charge is the proper response to that situation. For these reasons, IIEC's proposed adjustment is rejected.

The Commission rejects CNE's proposal, which would allow Transportation customers to sell gas withdrawn from storage to other entities. In the Commission's view, storage banking service is intended to provide Transportation customers with an opportunity to manage supply in meeting their own gas needs. It is not intended to provide customers the opportunity to use Nicor's storage assets for other purposes. The Commission is concerned that such a requirement could exacerbate Nicor's difficulty in managing its storage fields. The Commission also believes that CNE's proposal has the potential to impose additional costs on Nicor that are not necessary in the provision of utility service. For these reasons, CNE's proposal is rejected.

Cycling

Nicor

Nicor states that underground aquifer fields, including all the gas storage fields owned by Nicor, physically require that gas be seasonally cycled – that is, that gas is injected to near capacity and then drawn down each year. Nicor asserts that failure to properly cycle the storage fields would lead to loss of capability in the short run, and possibly, in the long run as well.

Nicor proposes to establish cycling targets for the use of gas storage by end use Transportation customers. Specifically, Nicor proposes that failure to bring stored gas levels to at least 90% by November 1, would result in reduction of Critical Day and Operational Flow Order ("OFO") Shortage Day withdrawal capability, and failure to reduce balances to 10% or less of the maximum inventory level by April 1, would result in a reduction in the customer's daily summer injection rights. Nicor believes that this leaves Transportation customers with significant flexibility; a Transportation customer can draw its entire storage down to zero during the winter season, fill it back up, and suffer no consequences so long as it draws down to 10% before April 1.

Nicor argues that under the current regime, in which there are no cycling targets for Transportation customers, it is possible, and even likely, that individual customers will actually work against Nicor's attempts to cycle its storage fields. According to Nicor, to the extent that end use Transportation customers elect to withdraw and inject gas in a manner inconsistent with the physical requirements of the fields, Nicor and its customers must either suffer a degradation of this valuable asset, or Nicor must use its own purchases to compensate.

Nicor describes as specious the argument that there is no need for cycling targets because Nicor has been cycling its fields every year, regardless of the activities of the Transportation customers. In Nicor's view, the fact that it has been acting prudently to keep the gas fields functioning misses the point of the proposed cycling targets for Transportation customers. Nicor avers that it is proposing that the Transportation customers do their part to help cycle the gas fields, instead of requiring Nicor to take action in response to their activity, thereby putting the increased cost on Sales customers. Nicor also disputes IIEC's assertion that it has not presented evidence that it has had to alter its purchases due to the activities of Transportation customers.

According to Nicor, IIEC avers that Transportation customers are not concerned with cycling, because cycling is Nicor's problem and only the Sales customers benefit from it. Nicor argues that gas storage fields that stay in good working condition are in every customer's interest and Nicor does need to cycle its fields. Nicor states that without proper cycling, the fields would suffer degraded performance, and allocations of storage rights and maximum withdrawal rates would have to decrease. Nicor also maintains that it is the Transportation customers' desire to withdraw and inject in ways that run counter to the orderly cycling of the fields that make cycling targets necessary.

Nicor argues that some of the Transportation customers, implicitly conceding that some target levels are necessary, argue that the target levels Nicor has chosen are too harsh. According to Nicor, Vanguard argues that with 90% and 10%, it is inevitable that there will be some customers that will oversupply while trying to achieve 90%, and will hit 0% while trying to achieve 10%. Nicor contends that there is no evidence for this in the record. Nicor avers that CNE suggests the targets should be 75% full by November 1, and 50% empty for April 1. Nicor again contends that there is no evidence to back these figures either, and they do not do much to help Nicor achieve its full cycling. Nicor asserts that Staff's suggestion to relax the April 1 target to 20%, while an improvement over recent Transportation customer cycling, would not be optimal.

Nicor dismisses CNE's suggestion that there must be flexibility in the date by which a Transportation customer hits its cycling targets. CNE contends that customers do not know their storage levels well enough to plan for hitting a target by a specific day, and suggests a thirty-day window. Nicor asserts that CNE's factual premise is incompatible with its other arguments on storage issues. According to Nicor, when discussing intraday nominations and the maximum daily nomination, CNE acts as if it monitors and manages its customers' storage assets on a daily, if not hourly, basis. Nicor provides daily storage balance information via a bulletin board several times a week.

Nicor also claims there are practical problems with CNE's suggestion. Nicor argues the daily read Transportation customers are billed on the first of the month, so November 1 and April 1 make the most sense. Nicor also asserts that it would not be feasible for the monthly read Rider 25 customers, because their storage level would only be estimated as of the first of the month. CNE's suggestion to allow super-pools would require considerable reprogramming of Nicor's billing system.

Staff

Staff supports Nicor's proposed 90% target level for injections by November 1 as reasonable, based upon Nicor's actual historic levels of injections by this date. Staff recommends that the critical day withdrawal penalty be based upon the 90% injection target and not 100% of the target. Staff states the 90% target should be sufficient for the penalty if it is sufficient for the level of injections, and that a penalty of this nature should be implemented gradually, given that Nicor has operated its system for at least 15 years with no such cycling or penalty provisions. According to Staff, given that the injection requirement is a significant change for Transportation customers, Staff recommends the compliance penalty as a gradual approach that may or may not need tweaking in the future.

Staff opposes the proposal to require a 10% target level for storage withdrawals by April 1 for Transportation customers. Staff states that while Nicor claims that its proposal is supported by the need to cycle gas out of storage so that gas can be injected for the next heating season, Staff witness Borden found no evidence that Nicor achieves this target level by the specified date, i.e., historically this does not appear to be an actual practice of Nicor. Staff contends that negative HUB balances are an indication that Nicor has historically loaned system gas at this time period. Staff asserts that such HUB loans, if they do not result in higher gas costs for Sales customers, can assist Nicor in cycling gas from storage.

IIEC

According to IIEC, currently, Transportation customers have the ability to manage their storage based on their own operating requirements and constraints and their own perceptions of the economics of storage. IIEC claims this is similar in manner to how Nicor operates its storage fields on behalf of the best interests the Sales customers.

IIEC avers that Nicor chooses to fill its fields at a target date of November 1 and empty the fields by April 1, although Nicor concedes it does not always hit its targets. IIEC claims this practice is driven by the heating needs of its Sales customers. Additionally, IIEC asserts that there is no reason that the fields should be filled precisely on November 1 and emptied (or nearly emptied) on April 1.

According to IIEC, it is not necessary for Transportation customers to fill and empty their storage banks in this seasonal fashion in order for Nicor to do so. IIEC asserts that Nicor has carried out its planned injections and withdrawals without imposing cycling requirements on customers for the last 10 years. IIEC maintains that Nicor can fill or empty its aquifer storage fields in whatever manner it wants to even if Transportation customers do not cycle their own storage banks at all, or even if they cycle their banks in a completely opposite pattern.

IIEC also disputes Nicor's argument that when Nicor must compensate for transportation storage activity, or inactivity, by adjusting its purchases, the Sales customers are adversely affected. IIEC observes that Staff witness Borden claimed to be unaware of any incident in the operation of the storage fields in the last 14 years that would require the type of cycling requirements proposed by Nicor. (IIEC Br. at 26, citing Tr. 1075-1076.)

IIEC presented hypothetical examples which, it asserts, demonstrate the opposite of the situation suggested by Nicor. IIEC asserts that in its example, the cost of purchased gas by Nicor was actually less in the scenario in which there was no cycling at all, than in the scenario where the transportation cycling was a perfect match to the physical monthly injections and withdrawals of Nicor.

IIEC states that in Nicor's rebuttal testimony Nicor substituted some historical gas prices and did show that the no cycling scenario resulted in a slight increase in the PGA costs. IIEC argues, however, that the only reason Nicor's counterexample "worked" was that it covered a period where there were higher gas prices in the withdrawal season than in the injection season. IIEC claims this is an atypical situation. IIEC urges the Commission to reject any requirements for maximum or minimum storage balances for Transportation customers.

IIEC disputes Nicor's assertion that Transportation customers have used their complete freedom of injections and withdrawals in ways that are detrimental to maintaining the operational integrity of the fields and forced the utility to work harder to keep its fields performing. IIEC claims that Nicor could not demonstrate this allegation of harm. IIEC adds that Nicor witness Bartlett could not provide evidence that Sales customers have been harmed in any way. IIEC also maintains that under what it views as a reasonable assumption that gas prices are higher in the winter withdrawal months than in the summer injection months, Sales customers are actually better off if gas is not cycled.

CNE

It is CNE's position that Nicor's own history in operating its storage fields demonstrates that the proposed cycling requirements are operationally unnecessary. CNE asserts that during the past 10-year period, Nicor has been able to properly cycle its storage fields, in the manner and to the levels deemed necessary, to meet its own operational and seasonal requirements without any maximum or minimum storage level requirements imposed on Transportation customers. CNE claims Nicor has never failed to properly cycle its storage fields in spite of no cycling requirements for Transportation customers. CNE also states that Staff did not prepare any analysis, study or provide other evidence that it is necessary to require Transportation customers to fill their storage to 90% or higher by November 1 in order to ensure the safe and reliable operations of Nicor's storage fields.

CNE also asserts that, over this 10-year period of time, Nicor has not met its own target levels—the ones Nicor seeks to impose on Transportation customers in maintaining its System Customer Storage level. CNE further claims that only once in the past nine years has Nicor storage level fell below 10% on April 1, averaging about 32% during the five most recent years.

CNE contends that Nicor failed to demonstrate the need and the appropriateness for the proposed cycling requirements. CNE claims that Nicor has been able to physically cycle its storage fields to operating levels for the heating season and withdrawal levels by spring in preparation for summer injections. CNE avers that under Nicor's existing tariff provisions, SBS capacity allocations to Transportation customers enabled them to utilize some of Nicor's storage assets to inject and withdraw their own gas supply. In CNE's view, during the past 10 years these two functions have co-existed without harm to Nicor's storage operations or its tariff supply customers and without the need for the cycling requirements on Transportation customers that Nicor now states are necessary for the integrity of its storage fields. CNE argues that Nicor has not linked the need for these cycling requirements to either maintaining the operational integrity of its storage fields or protecting Nicor and its customers from losing these assets or paying more for it.

CNE claims that on one hand, Nicor witness Mr. Bartlett states that Transportation customers tend to over-inject when injections for Sales customers should be occurring, presumably referring to the spring and summer injection period and implying that Sales customers are harmed. CNE asserts that Mr. Bartlett also claims that Transportation customers under-inject during the spring and summer. CNE contends that it is Nicor's proposed cycling requirements that present the real potential for higher costs to Sales customers, not the behavior of Transportation customers.

CNE argues that the Commission should disregard what it describes as conflicting testimony that Nicor has presented to support the alleged need for cycling requirements. CNE maintains that for the past 10 years both Transportation customers and Sales customers have been able to utilize Nicor storage field assets without harm to one another. CNE asserts that Nicor presented no studies or analysis that calculated actual financial losses suffered by Sales customers due to the injection and withdrawal patterns of Transportation customers since January 2000. CNE also asserts that Staff witness Borden acknowledged that Transportation customers' failure to fill storage by

90% by November 1 will not necessarily harm Sales customers; it could actually help Sales customers. (CNE Br. at 31, citing Tr. 1077.)

CNE contends that Nicor has not met its burden of proof that cycling requirements are necessary as discussed above. However, if the Commission is inclined to approve cycling requirements for Nicor, CNE argues that one additional step should be taken–-an independent verification of the Fairchild-Wells study that Nicor relies on, at least in part, to support its need for cycling requirements.

CNE believes that the Commission could benefit from a second view of the Nicor storage fields. CNE asserts that such a study would not unduly delay implementation of cycling requirements, if ultimately deemed necessary, and could help ensure that the restrictive measures proposed by Nicor that have been unnecessary for the past ten years are 100% necessary.

In CNE's view, while it is clear that Nicor itself has not consistently achieved the target levels it proposes for Transportation customers, this is especially the case with regard to the April 1 date. CNE emphasizes that on average as of April 1 during the period 2000 through 2004, storage for Nicor's system customers was 32% full. CNE argues that if cycling requirements are implemented, Nicor's proposed 10% target level by April 1 is unwarranted based upon Nicor's own history.

CNE asserts that Nicor's existing tariffs could make it difficult for a Transportation customer to meet the proposed 10% target level. CNE avers that Nicor's existing storage service tariff limits a customer's ability to reduce storage; the only real option is an extremely uneconomic one, to burn off gas. According to CNE, a warm March could also preclude a customer from compliance with the target. CNE claims these are real-life possibilities which support the need for the additional tools that CNE proposes that Nicor make available to Transportation customers to facilitate compliance with cycling requirements.

If the Commission finds that cycling requirements are appropriate, CNE suggests the Commission adopt a more moderate target level. CNE asserts that a more moderate target level would be sufficient particularly, given the absence of any operational emergency, or even need, presented by Nicor for justification for the proposed cycling requirements. CNE avers that using Nicor's most recent experience, the most stringent April 1 target warranted would be 32%. CNE believes a target level at 50% would meet the Commission's goal of moderation. CNE claims this is a level that is similar to what is used by Natural Gas Pipeline (NGPL) in its DSS tariff. CNE asserts that Nicor admitted that it could implement other target levels, but had performed no study or analysis to support other levels. It is CNE's position that absent any study or analysis validating a particular target level, the Commission should reject cycling requirements, or at minimum accept a more moderate target level such as 50%.

CNE requests that the Commission reject Nicor's proposed target level for November 1. CNE recommends that the Commission direct Nicor to implement a 75% target level for November 1 if it deems cycling requirements appropriate.

If the Commission concludes that cycling requirements are reasonable, CNE suggests that compliance with the target levels be measured over a period of time, such as the 30-day period used by Natural Gas Pipeline, instead of through a single, specified date. CNE suggests that if a 50% target level is to be achieved at the end of the heating season, compliance would be achieved through attaining 50% at any single date throughout a 30 day window at the end of winter. CNE contends that the physical nature of the fields does not require them to be filled by November 1 and emptied by April 1 of each year. CNE avers that Nicor acknowledged that currently each of its fields operates differently throughout the year with different timing of when fields are emptied and filled. CNE claims that each of the eight Nicor storage fields can be cycled at different times, allowing Nicor to maintain deliverability without requiring a date-certain in order to achieve effective cycling.

CNE states that Nicor seeks compliance at a single specified point in time, however, the customer or marketer may not have operational data available from Nicor that clearly delineates the volume that is currently in a customer's SBS account until days after the fact. CNE asserts that this reporting delay complicates the ability of a customer or marketer to achieve a specific percentage-fill at a single point in time, especially as a day or two of customer's usage could represent 10% or more of a customer's storage account capacity. CNE claims that a lag of several days before receiving daily usage reports makes it virtually impossible to know actual storage levels within 10% accuracy at a particular point in time.

CNE believes that Nicor's proposed penalty provisions for noncompliance with the target levels are punitive and do not provide incentives for compliance. In particular, CNE asserts that the penalty for noncompliance with the April 1 target, as proposed, would make it difficult for a customer to comply with the subsequent November 1 target, thereby, potentially ensuring continued noncompliance rather than providing an incentive to comply.

CNE asserts that Nicor has provided transportation service for over 15 years without any cycling requirements and that it is unnecessary to implement any cycling requirements with penalties that are unduly harsh. CNE suggests that if the Commission approves cycling requirements, in order to make compliance with target levels attainable, the Commission should adopt the CNE proposal to cap the reduction in withdrawal and injection rights.

Under CNE's proposal, when a compliance level of 50% or less is achieved for November 1, a cap on further reductions in withdrawal rates should be put in place in order to maintain a reasonable ability for a customer to meet an April 1 target. CNE states that if Staff witness Borden's proposal is approved, when a target level of 50% or less is achieved by November 1, withdrawal rights are capped at a 1.26% level. CNE adds that when a compliance level of 50% or more is achieved for April 1, a cap on further reductions in injection rights should be put in place in order to maintain a reasonable ability for a customer to meet the subsequent November 1 target. In CNE's view, at some level it becomes counterproductive to continue to reduce storage withdrawal and injection rights if the goal is to achieve the next target level. CNE recommends that the Commission adopt Commission Staff's noncompliance penalty modified by CNE's proposal to cap any proposed penalties.

Commission Analysis and Conclusions

Nicor proposes to establish cycling targets for the use of gas storage by end use Transportation customers. Under Nicor's proposal, failure to bring stored gas levels to at least 90% by November 1 would result in reduction of Critical Day and OFO Shortage Day withdrawal capability, and failure to reduce balances to 10% or less of the maximum inventory level by April 1 would result in a reduction in the customer's daily summer injection rights. Nicor argues that the cycling targets are needed so that it can properly cycle its storage fields.

Staff supports Nicor's proposed 90% target level for injections by November 1 based upon Nicor's actual historic levels of injections by this date. Staff recommends that the critical day withdrawal penalty be based upon the 90% injection target rather 100% of the target as proposed by Nicor. Staff argues that its proposed penalty is sufficient to provide suppliers with an incentive to meet the November 1 injection target. Additionally, Staff objects to Nicor's proposed withdrawal target. Staff believes the April 1 withdrawal target is unwarranted because Nicor has not historically met that target itself.

IIEC and CNE oppose the proposed cycling targets. Among other things, they argue that the proposals will interfere with the operational needs of Transportation customers and that historically Nicor has, and can continue to, cycle its storage fields without imposing this additional burden on Transportation customers.

The record demonstrates that in operating its system, one of Nicor's most important responsibilities is to efficiently and effectively manage its storage fields. Having sufficient gas in storage entering the winter season is vital in Nicor's ability to meet winter demand and to manage the cost of meeting peak winter demand. While requiring Transportation to have their storage capacity filled to 90% by November 1 may diminish the flexibility of Transportation customers to utilize storage, in light of the importance of storage in the winter season, it is reasonable. Although Nicor has previously managed to operate its storage fields in the absence of this requirement, the Commission views this as an operational measure that will enhance Nicor's ability to provide adequate and reliable service without imposing an unreasonable burden on Transportation customers.

On the other hand, the record does not support Nicor's proposed requirement that Transportation customers reduce storage volumes to 10% by April 1. While the Commission does not question Nicor's need to fully cycle its storage fields, it is not clear Transportation customers, or Nicor for that matter, need to reduce storage volumes to 10% by April 1. That Nicor will benefit from the cooperation from Transportation customers in ensuring that storage is nearly full before the winter season is clear. Imposing the additional requirement that Transportation customers nearly empty storage capacity by April 1, however, is not warranted. The record shows that historically, Nicor has not routinely reduced storage volumes to 10%, or nearly 10%, by

April 1. Additionally, the other parties have convinced the Commission that, to the extent Nicor actually needs to reduce the amount of gas in storage after the end of the winter heating season, Nicor should be able to accomplish this without placing this additional withdrawal burden on Transportation customers at this time. Finally, the intervenors raised a legitimate concern that combining a withdrawal target with the injection target might be particularly burdensome for Transportation customers.

Nicor's proposed injection penalty is intended to provide Transportation customers an incentive to meet the injection target by November 1. Staff suggests that a lesser penalty, based upon the 90% injection target not 100% of the target as Nicor proposed, would provide an adequate incentive for Transportation customers to meet the injection target. Given there is currently no injection target or associated penalty and the response of Transportation customers to these requirements is not known, the Commission believes it is best to take a measured step in implementing a storage injection target penalty at this time. The Commission, therefore, adopts Staff's recommendation for the penalty in the event of failure to comply with the injection target. Of the two proposals in the record, the Commission finds Staff's to be superior. If, in an appropriate forum in the future, Nicor can demonstrate that a higher penalty is needed to compel Transportation customers to meet the injection target, the Commission will consider allowing Nicor to raise the penalty.

Super Pooling

Nicor

Nicor does not support CNE's proposal for super pooling. Nicor claims that balancing for each individual group will result in increased incentives for the supplier to meet the cycling requirements and better conformance to the cycling requirements. Nicor contends that it would provide a benefit to all customers that suppliers meet the cycling requirements at the group level, not groups of groups. Nicor also argues that its proposed cycling targets of 90%/10% were based on the existing pool sizes. In Nicor's view, if super pools are accepted, the targets should be changed to closer match 100%/0%.

CNE

CNE proposes that the Commission require Nicor to offer the use of super pools as one of the tools for Transportation customers and marketers to mitigate what it views as the negative rate impacts of Nicor's proposed cycling requirements and target levels. CNE claims that super pooling is a simple and straight-forward process where the total storage volumes for all groups of customers under the common management of the same marketer are used to determine compliance with both the November 1 and April 1 target level.

CNE argues that if Nicor is truly interested in simply ensuring the cycling of gas volumes, then there is no logical reason to object to the pooling of gas between groups in order to determine compliance with the target levels. As an example, CNE states that for a marketer with three separate groups, in determining compliance with a target level, Nicor would add the amount of gas in storage for all customers in each of the three separate groups and then calculate that as a percent of the total storage capacity for each of the three groups under common supplier management. This single percent would then become the basis to determine whether compliance with the appropriate target level was achieved.

CNE claims the super pool proposal is only a tool to allow a marketer with multiple groups of customers to treat all the storage volumes it has delivered to Nicor's storage fields to count – in total – as the target level that a marketer is required to meet. The super pools would help facilitate Nicor's goal of cycling gas volumes by helping marketers and their customers reach compliance with target levels. CNE asserts that Nicor provides no evidence or any credible testimony as to why super pools should not be allowed. CNE states that there is nothing inherent in the super pool proposal that would impact Sales customers.

Vanguard

If the Commission approves cycling of storage gas at a stipulated maximum and minimum percent of a given storage bank capacity, then Vanguard recommends that the Commission require Nicor to treat marketers as an aggregation of each marketer's entire portfolio of Transportation customers. Vanguard asserts that this idea is similar to Nicor's treatment of storage bank capacity depicting all Transportation customers together in aggregate.

Vanguard avers that Nicor's intention is to ensure that Transportation customers are cycling at a particular level of bank capacity. Vanguard states that in most cases, each marketer is responsible for deciding upon the quantity and timing of gas deliveries for their respective customers. Vanguard asserts that; therefore, the responsibility should reside with the marketer to ensure that its aggregate portfolio of customers meets the threshold maximum and minimum gas storage bank capacities.

Vanguard states that there are atypical load shape customers, or atypical load shape accounts of particular customers, including but not limited to chillers, swimming pools, asphalt, concrete, and grain dryers. Vanguard claims that Nicor cannot intend to penalize these individual customers because of their inverted load shape, as opposed to the traditional heat-load profile. For example, a swimming pool account will consume one hundred percent of its annual consumption during the period from May through October. An asphalt plant may consume ninety percent of its annual usage during the period from April through October and the remaining ten percent during the period from November through March.

According to Vanguard, establishing the precedent that each account will be judged by Nicor on November 1 to see if the account has met the stipulated storage bank maximum or minimum is flawed at best. Vanguard asserts that a business that has an inverted load shape cannot be expected to procure the necessary natural gas needed to fill the account's storage bank to at least the stipulated maximum value by November 1, knowing that there is little hope the account will consume enough gas to drain the storage bank balance to at least the stipulated minimum level by April 1. Vanguard contends that with the current trend in natural gas commodities prices, such action on the part of an inverted load shape customer will involve an extremely high cost of capital and an immeasurable lost opportunity cost for the business owner.

Vanguard claims the alternative for these inverted load shape accounts is to terminate transportation service with the marketer and return to Nicor as a Sales customer. Vanguard asserts that at that point Nicor would not look at the customer individually to see if the sales account met the stipulated injection and withdrawal cycle. Instead, Nicor would include this individual account as a member of the much larger aggregation of all Sales customers.

If the Commission determines that cycling of transportation accounts is a necessary change in Nicor's tariff, Vanguard suggests that the Commission require Nicor to view each marketer as an aggregate of all its customers for the purpose of determining whether the stipulated maximum or minimum storage bank capacity threshold is met, rather than assess each marketer managed account individually.

Commission Analysis and Conclusions

Both CNE and Vanguard argue that if the Commission were to adopt Nicor's proposed cycling targets, Nicor should be required to allow a marketer to aggregate the storage volumes for all groups of customers under common management to determine compliance with the proposed November 1 and April 1 target levels. They claim their proposal mitigates the adverse impact of the cycling requirements while still accomplishing Nicor's goal of improved cycling of storage fields. Nicor opposes the intervenors' proposal, arguing that it would reduce the incentives for suppliers to meet the cycling requirements.

As discussed immediately above, the Commission adopted Nicor's proposed injection target but rejected its proposed withdrawal target. The Commission does not understand Nicor's objection to this proposal. Nicor does not explain why it would have an affect on the incentives facing suppliers. Additionally, it is not clear to the Commission why allowing suppliers to aggregate groups would have any effect on the appropriate injection target. Even assuming there is some merit to Nicor's argument, the Commission must balance Nicor's desire to obtain the cooperation of Transportation customers in operating the gas system with the adverse impact on those Transportation customers.

Also as mentioned above, Nicor has been and is currently operating its system without any cycling targets. To mitigate the adverse impact of cycling requirements adopted above, and the absence of a better reason than those offered by Nicor, is reasonable to allow suppliers to pool their groups of customers to determine compliance with the injection target adopted.

Level of Rate Increase: Rates 4 & 74; Rates 6 & 76; Rates 7 & 77

Nicor

Nicor claims it has proposed to allocate costs to customer classes to more accurately reflect the cost of serving those customers, subject to the rate design objectives discussed in its testimony, and this requires an increase in various rates. According to

Nicor, CNE opposed the increase to transportation rates as being too great from a policy standpoint. Nicor states that IIEC also took issue with the level of rate increase for Transportation customers, but from a cost of service standpoint, in regard to both Nicor and Staff proposals.

Nicor agrees with CNE that the impact of any rate increase should be given some consideration once the proper revenue requirement has been determined. Nicor avers that starting with a properly constructed ECOSS, Nicor would still limit the increase to Rate 1, Residential Service, as it originally proposed. Nicor asserts that to get to equalized rates of return would require residential customer rates to increase by about $76 million, even though Nicor's requested total increase is $77,573,000. Nicor proposes limiting the residential class rate increase to about $55.6 million or 72% of the approved residential class base rate increase. Nicor also proposes that the total remaining revenue requirement, which would include the remaining $22.0 million revenue increase, should be allocated proportionally to the non-residential classes based on the results of the ECOSS, excluding Rates 17 and 19 which have individual contract services. Nicor avers that this results in an increase of about 17.2% in base rates for residential customers and 13.1% for commercial and industrial customers.

According to Nicor, IIEC's proposal would result in approximately a greater than $76 million increase to residential customers and a decrease for commercial and industrial customers. Nicor believes the Commission should adopt its proposed rate increases for Transportation customers rather than accept IIEC's proposal to place more than the entire revenue requirement increase burden upon residential customers.

Nicor maintains that its proposal moderates the residential rate increase consistent with concerns regarding gradualism and is just and reasonable. According to Nicor, Staff's position simply reflects the results of the differences in proposed revenue requirements, the differences in revenue requirement allocation proposals, the differences in proposed rate designs, and what Nicor describes as the errors in Staff's ECOSS. In Nicor's view, Staff was wrong to propose setting the transportation rates, Rates 74, 76, and 77, too high by failing to adequately reflect that Transportation customers separately pay SBS costs.

According to Nicor, Staff defends its proposed increases to Rates 76 and 77 customers by comparing them to increases to in the cost of gas supply. Nicor claims that viewed in that light, Nicor's entire proposed base rate increase has only a relatively small impact on residential and non residential customers.

Nicor states that Rate 4 and Rate 74 are "companion" rates for sales and Transportation customers respectively. The Company asserts that the design of those two rates should be coordinated to avoid creating false incentives for switching between the two rates. Nicor also contends that the structure proposed by Staff should be rejected for the same reasons discussed with its Rate 1 proposal.

Staff

Staff states that Rate 4 is a "companion" rate with Rate 74, as well as Rates 10 and 11, which means that the rates should be similar because the rates apply to basically the same customer population. According to Staff, Rate 4 applies to mostly Sales customers whose gas supplies are purchased from Nicor, while Rate 74 applies to mostly Transportation customers that arrange their own gas supplies. As with Rate 1, Nicor is proposing a customer charge and declining three-block distribution charge for Rates 4, 10, 11, and 74, but the customer charge would vary according to meter class (Nicor Gas Exhibit 44.4, p. 3, ll. 15-23). Staff asserts that since customers moving to Rates 5 and 75 are currently Rates 4 and 74 customers, when comparing revenue recovery to cost of service, newly proposed Rates 5 and 75 should also be included in revenues, even if the Company has not updated its ECOSS to separate Rates 5 and 75. Staff claims that, based upon the Nicor ECOSS, Rates 4, 5, 10, 11, 74, and 75 revenues, under the Company's proposed rates, it would recover $172,155,000 in revenues (Nicor Gas Exhibit 44.4, pp. 3, 4, 5, and 6, column (E), ll. 31, 53, 94, 117, 161, and 190). According to Staff, with a combined $153,696,000 cost of service (Nicor Gas Exhibit 42.1, Schedule F, p. 1, l. 7, "Total" columns for Nonresidential – Rate 4 – General, Rate 10 – Compressed Natural Gas, Rate 11 – Energy, and Rate 74 – General Transportation), Nicor's proposed Rates 4, 5, 10, 11, 74, and 75 would therefore recover $18,459,000, or 12 percent, more than cost of service.

Staff witness Luth also recommends a three-level customer charge for Rates 4 and 74 that depends upon the customer's meter class (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, p. 1, ll. 15-18). Unlike the Company's proposed Rate 4 customer charge, however, Staff's proposed customer charge allocates the increase in test year customer costs among all three meter classes, rather than increasing only the first, or smallest, meter class customer charge from current rates. Under Staff's proposal, the increase in test year Rates 4 and 74 customer costs over customer charge revenues at present rates should be paid by all Rate 4 customers, not just the smallest meter class, as would be the result under the Company's proposed Rate 4 and 74 customer charges.

Staff states that the differences between the Nicor and the Staff proposed Rates 4, 10, 11, and 74 volumetric distribution charges are similar to the differences in the Rate 1 – residential volumetric distribution charges, namely, that Nicor continues to propose a declining three-block structure (Nicor Gas Exhibit 44.4, column (D), pp. 9, 10, 11 and 74, ll. 20-22, 85-87, 108-110, and 144-146), while Staff recommends a nearly flat, or uniform, two-block structure (ICC Staff Exhibit 16.0-Revised, Schedule 16.6-Revised, column (F), pp. 1, 3, 4, and 5, ll. 19-22, 69-71, 92-94, and 127-130). Staff claims that Rate 74 distribution charges are lower than the comparable Rates 4, 10, and 11 distribution charges to reflect the removal of the Uncollectible Accounts Expense allocation from Nicor gas supply billings from transportation rates in the pooled, companion rates cost of service (ICC Staff Exhibit 16.0-Revised, p. 17, ll. 349-352).

Staff avers that for the same reasons that a nearly flat, or uniform, distribution rate should be applied to Rate 1, the Rates 4, 10, 11, and 74 distribution charges should also be nearly flat. According to Staff, nearly flat distribution charge treats each therm as being nearly the same cost to deliver and, therefore, is more closely linked to the approach taken in allocating demand and volume costs recovered through the distribution charge. Staff argues that Nicor's proposed declining block distribution charge structure suggests that increased demand is less expensive than lower demand, which is contrary to how demand costs are allocated. It is Staff's position that since demand costs are primarily allocated according to peak demand, which represents distribution in the highest volumes of distribution charge billing, on the theory that higher demand causes higher costs, it is not logical to discount the billing in the highest volume distribution charges. Staff believes that, as with residential Rate 1, the Commission should implement Staff's two-block, narrowed declining block distribution charge structure for Rates 4, 10, 11, and 74, so that demand billing more closely resembles cost allocation.

Staff avers that under Nicor's proposed rates, the increase for Rate 76 customers would be accomplished through a reduction in the Rate 76 customer charge, from $474.00 per month to $225.00 per month, combined with a 71% increase in the volumetric distribution charge. Staff avers that overall, Nicor's proposed Rate 76 increase would be 31.52 percent, including SBS revenues.

Staff recommends an overall increase in revenues from Rate 76 customers of approximately 19.6 percent. Under Staff's proposed rates, the Rate 76 customer charge would increase slightly from $474.00 per month to $481.23 per month, the volumetric distribution charge would also increase, from 1.38¢ per therm to 1.74¢ per therm, and the SBS charge would increase from 0.39¢ per therm to 0.45¢ per therm. Staff states that the average amount paid per therm, including customer charge, distribution charge, and SBS charge applied to maximum capacity under Staff's recommended Rate 76 would be 2.833¢ per therm, an average increase of 0.464¢ per therm.

Staff states that under Nicor's proposed rates, the Rate 77 customer charge would be reduced, from $597.00 per month to $300.00 per month, a reduction of nearly half. Staff states that Nicor proposes for the Rate 77 demand charge to increase, from the current 46.33¢ per therm of demand in the first block and 1.55¢ per therm of demand in the second block to 66.96¢ per therm of demand up to 10,000 therms, and 5.24¢ per therm of demand over 10,000 therms. Staff claims that overall, the Nicor proposed Rate 77 increase would be 30.4 percent, including SBS revenues.

Staff recommends an overall increase in revenues from Rate 77 customers of approximately 47.7 percent. Under Staff's proposed rates, the Rate 77 customer charge would increase, from $597.00 per month to $877.00 per month and the Rate 77 demand charge would increase, from 46.33¢ per therm of demand in the first block and 1.55¢ per therm of demand in the second block to 64.86¢ per therm of demand up to 10,000 therms, and 10.14¢ per therm of demand over 10,000 therms. Staff claims that the average amount paid per therm, including customer charge, distribution charge, and maximum SBS charge under Staff's recommended Rate 77 would be 2.491¢ per therm, compared to 1.686¢ per therm under current rates, with an average increase of 0.805¢ per therm.

According to Staff, IIEC does not favor increases averaging 0.464¢ per therm under Rate 76 and 0.805¢ per therm under Rate 77. Staff claims its proposed rates under Rate 1 would recover $365,240,000 in test year revenues, compared to test year revenues under current rates of $325,411,000. Staff states that under its proposed rates, Rate 1 customers would pay an average of 15.69¢ per therm, compared to an average of 13.98¢ per therm under current rates, an average increase of 1.71¢ per therm. Staff asserts that its proposed average per-therm increase for Rate 1 is close to four times Staff's proposed average increase per Rate 76 therm, and more than double the average increase per Rate 77 therm (1.71¢ per therm under Rate 1 compared to 0.464¢ per therm under Rate 76 and 0.805¢ per therm under Rate 77). Thus, Staff concludes that Nicor's proposed average increases per therm under Rates 76 and 77 are considerably less than Staff's proposed average increase per therm under Rate 1. Staff also asserts that Rate 1 customers would pay more than five times the average amount per therm that Rate 76 customers would pay and six times the average per therm that Rate 77 customers would pay under Staff's proposed rates.

Staff believes that when evaluating its proposed rates, the total cost of gas service, which would include the cost of gas supply must be considered. Staff asserts that its proposed average per-therm increases for Rates 76 and 77 are small when compared to increases in the cost of gas supply discussed by IIEC witness Dr. Rosenberg. Staff avers that compared to the 35+¢ per therm increase in gas supply costs discussed by Dr. Rosenberg, Staff's proposed average increases of 0.464¢ and 0.805¢ per therm under Rates 76 and 77, respectively, for distribution are minor. Staff argues that, if revenue recovery under Rates 76 and 77 is reduced below cost of service, other rates will have to pay more than cost of service, if Nicor is allowed the opportunity to earn its authorized rate of return. Since Rates 76 and 77 are already the lowest cost rates per therm, Staff believes other rates should not be required to subsidize Rates 76 and 77.

In response to IIEC, Staff maintains that its proposed increase for Rate 77 is not disruptive because the increase is justified. Staff argues that its 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'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.

Staff states that the average Rate 77 per-therm increase under its 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, more than double the average Rate 77 per-therm increase. Staff argues IIEC's depiction of Staff's recommended average 2.461¢ per therm under Rate 77 as "disruptive" is overstated because gas supply is now at least 70¢ per therm. Staff states that gas supply costs of at least 70¢ per therm are more than 28 times Staff's average charge per therm under Rate 77, which in Staff's view, completely overshadows its recommended Rate 77 cost for distribution.

IIEC

IIEC urges that the increase to the Rate 76 and Rate 77 classes, under any circumstance, should not exceed the amount indicated by a proper embedded cost of service study. According to IIEC, Nicor is proposing to recover more costs in the volumetric component, contrary to the indications of either cost of service study and contrary to the testimony of Nicor witness Gordon who implied that less fixed cost should be recovered in the volumetric component. IIEC asserts that both Nicor and Staff are proposing disruptive increases in the tail-block demand charge of Rate 77. IIEC avers that Nicor proposed 275% increase in the tail block of the demand charge for Rate 77, while Staff proposed a 981% increase in the tail block in direct testimony and a 554% increase in the tail block in rebuttal testimony. IIEC argues that these increases are not justified. IIEC argues they would be particularly troublesome for customers whose usage is primarily in the tail block. If IIEC's proposals are rejected, IIEC's position is that the only reasonable rate design would be uniform changes in the rate component.

According to IIEC, Nicor proposes to reduce the customer charge for Rate 77 by half and to radically increase the blocked demand charge as well as the volumetric charge. IIEC avers that Nicor proposed an increase tail block of the demand charge from 1.55 cents to 5.81 cents and proposes to increase the volumetric charge from 0.30 cents to 0.48 cents. While the customer charge appears to be supported by Nicor's ECOSS, neither the volumetric charge nor the demand charges appear to be supported by that study. IIEC also asserts that the volumetric charge is not supported by the embedded cost of service study performed by the Company. IIEC recommends that the initial block of the demand charge for Rate 77 be increased or decreased by the same percentage by which the total delivery revenue target (excluding storage revenues) is increased or decreased. With regard to the tail block demand charge, if total revenues for Rate 77 are slated to decrease, IIEC argues the tail block should remain at current levels. IIEC avers that if Rate 77 revenues are targeted to increase, then the tail block demand charge should be increased by the same percentage increase in delivery service revenues for Rate 77. In IIEC's view, this would maintain the relationship between the initial block and the tail block demand charge.

With regard to Rate 76, IIEC avers that Nicor proposed to cut the customer charge in half and increase the volumetric charge by 60%. IIEC recommends a seasonal delivery charge for Rate 76 because it does not have a demand charge, and it is important that cost consequences of winter usage—which is supported by both Nicor's cost study—be reflected in the volumetric charge.

IIEC claims that the volumetric charge for the winter months should be set at the current level of the Rate 76 volumetric charge. Then it would be adjusted upward or downward by the percentage change of the total revenues for Rate 76 approved by the Commission. The volumetric charge for the non-winter months should be set a one-half the winter charge. The cost analysis would have supported a greater differential, but IIEC proposes a ratio of winter to non-winter charges of 2:1 for the purpose of rate continuity and moderation.

IIEC argues that the customer charge should be set at a level necessary to reach the revenue target for Rate 76, but not less than $205 per month. According to IIEC, if the customer charge needs to be raised, the volumetric charges should be adjusted downward accordingly.

According to IIEC, Staff's per therm analysis is an inappropriate yardstick for evaluating the impact of a rate increase on a particular customer class. IIEC claims the correct measure of the impact of a rate increase on a customer class is the magnitude of that increase on a percentage basis, relative to existing rates. IIEC argues that it is important to consider existing rate levels when evaluating the impact of a proposed rate increase. IIEC contends that a $10 million rate increase may be relatively small for a customer class contributing $400 million in revenues at current rates; however, that same $10 million increase would have an enormous impact on a customer class that currently provides only $10 million in revenues. Staff's effort to express its proposed rate increases on a per therm basis is an attempt to disguise the dramatic adverse impact that its proposals would have on high load factor Transportation customers.

IIEC contends that Staff's approach to measuring rate impacts in this case is at odds with the Commission's rules. Citing 83 Ill. Adm. Code § 285.5135, IIEC claims that the Commission requires that rate impacts be determined on a bill comparison basis. IIEC avers that the bill comparisons are made separately for the residential, commercial and industrial classes based on various levels of usage within each class. IIEC maintains that the Commission does not compare unit charges for residential customers to unit charges for industrial customers to determine the reasonableness of an increase.

IIEC also objects to Staff's suggestion that the impact of Staff's proposed rates should be considered in the context of the total cost of gas service, including the cost of gas supply. IIEC claims that this rate case is focused on Nicor's transportation costs for both sales and Transportation customers. According to IIEC, if Staff is right, Nicor could argue that the size of its increase and its impact on customers is not an important consideration. The cost of gas supply is irrelevant.

IIEC argues that there is no legitimate basis for suggesting its rate proposals are unfair. The true inequity lies in the rate proposals submitted by Staff and Nicor, because these proposals deviate from cost-based rates to benefit residential customers at the expense of Transportation customers. Citing Docket 88-0277, IIEC avers that the Commission previously required Nicor to file a revenue-neutral rate case to better align its revenue allocation with cost causation principles. IIEC asserts that this demonstrates the emphasis the Commission places on eliminating cross-subsidies in Nicor's rates.

CNE

According to CNE, the impact of Nicor's original rate design on Rate 74 customers using more than 240,000 therms annually is 30% or higher. CNE avers that Staff's original rate design suggests even more severe results for these customers, increases of 63% to 100%. For Rate 76 large volume customers, CNE states that Nicor's original rate design results in 40% to 42% increases, while Staff's recommended rate design produces 46% to 51% increases for the CNE-Gas customers analyzed. CNE adds that for certain Transportation customers, under Staff's proposed rate design proposal customers could experience rate increases of 50%, 100% or even 500%.

CNE argues that rate increases of the magnitude proposed for Rate 74 and 76 customers are counter to the concepts of rate stability and gradualism, would be extremely harmful to Illinois industry, and negatively affect economic development in Illinois. According to CNE, rate increases of 70% or more could result in the loss of industrial load as customers revisit their operations. CNE claims this could ultimately lead to the necessity to file additional rate cases. CNE states that while a typical residential customer experiences a 7.3% rate increase under Nicor's original proposal, and a 2% decrease under Staff's recommendation, a large Transportation customer's utility distribution bill could nearly double in magnitude. CNE contends that while even a 7% rate hike can result in hardship for certain customers, doubling rates are problematic for a greater number of customers. If a rate increase of the magnitude proposed by Nicor or Staff is approved, CNE recommends that the Commission phase-in such steep rate hikes over a two-year or longer period.

Whatever revenue requirement is approved by the Commission, CNE recommends that this revenue requirement be allocated across all classes of customers in a fair and equitable manner based upon the concept that the cost-causer pays. CNE agrees that Rate 74 and 76 customers should shoulder their appropriate burden of any reasonable rate increase. However, CNE urges the Commission to avoid unnecessary rate shock by phasing-in large percentage increase over a multi-year period. CNE claims such action would somewhat mitigate the impact of severe rate hikes on a monthly and annual basis to the affected customers. CNE requests that any significant rate increase approved for Rate 74, 76, and 77 customers be phased-in over no less than a 2-year period.

Commission Analysis and Conclusions

As discussed above, the Commission has adopted, for the most part, Nicor's ECOSS as contained in its surrebuttal testimony. Because the rate base and operating income statement approved above vary from those proposed by Nicor, it will be necessary for Nicor to recalculate its ECOSS and establish new rates based upon the conclusions reached in this order.

CNE expressed concern about the possibility of rate shock and suggested the Commission consider a two-year "phase-in" of any rate increase that is too high. While the Commission shares CNE's concerns about the possibility of rate shock, the "phase-in" proposal was not adequately developed in the record. Specifically, CNE did not adequately address the appropriate levels of rate, in each of the two years or how, if at all, Nicor would be made whole for any lost revenues in the first year of a "phase in." As a result, the Commission cannot adopt a phase-in this proceeding.

Under Nicor's originally proposed rate design, Rates 4 and 74 were developed together by combining the allocated revenue requirements. Next, the monthly customer charges and tail block rates were set at or near the marginal cost. Third, any remaining revenue requirements were allocated to the remaining blocks on a cents per therm basis. Finally, an adjustment was made to reflect the storage banking service (SBS) revenues that the Rate 74 companion transportation rate would recover. (Nicor Ex. 32.0 at 30) Nicor modified its proposal such that the monthly customer charges for the three meter classes would remain as Nicor proposed, and revenue increases would be allocated over the distribution therms with the tail block set at the marginal cost and the remaining revenues prorated over the first two blocks on an equal cents per therm basis over current charges.

The Commission agrees with Nicor that Rates 4 and 74 should be developed by first combing the allocated revenue requirements determined in a manner consistent with the other decisions in this Order. However, the Commission does not agree that these customer charges should be set at Nicor's calculated marginal cost of service. Thus, the Commission adopts Staff's proposed customer charges for Rates 4 and 74, which vary with the customer's meter class. As with Rate 1, and for similar reasons, the Commission rejects Staff's proposal to move the distribution or usage rates for these rate classes to a flat structure at this time. Thus, the tail block for Rates 4 and 74 should be set at the level proposed by Nicor and any remaining revenues prorated over the first two blocks on an equal cents per therm basis over current charges. Nicor should file tariffs for Rate 4 and Rate 74 that reflect these conclusions.

The Commission also concludes that Rates 6 and 76 should be considered companion rates and should be designed together. The Commission also finds that Rate 76 should reflect the fact that storage costs will be recovered through the SBS charge. Under Nicor's proposed rates, the Rate 76 customer charge would be reduced from $474.00 per month to $225.00 per month, while Staff proposes to increase the charge to $481.23 per month. Nicor's proposed customer charge for Rate 6 is $25 per month less because Rate 76 customers pay a separate administration fee. Staff's proposed customer charge for Rate 6 is $456.23. IIEC has proposed to significantly increase the monthly customer charge based upon its ECOSS proposal.

As discussed above, the Commission did not adopt IIEC's ECOSS proposal and does not believe that its proposed increase in the monthly customer charge is warranted. The Commission has previously decided that Nicor's marginal cost of service study should not form the basis for establishing rates in this proceeding and thus, Nicor's proposal to set the customer charge at the marginal cost is similarly rejected. The Commission believes it is reasonable to maintain the customer charge for Rate 76 at $474.00 per month and to set the customer charge for Rate 6 at $449.00 per month. While the Commission is convinced that the Rate 6 charge should be $25 per month lower than the Rate 76 charge, neither Staff nor IIEC have justified increasing the customer charge over the existing level.

The distribution charges for Rates 6 and 76 should be set at a level that will recover the revenue responsibility assigned to those classes. The Commission concurs with Nicor that the distribution charge for Rate 6 should be higher than that for Rate 76. The storage costs included in the Rate 6 distribution charge should be removed to obtain the Rate 76 charge, which excludes storage costs through the SBS charge. Thus, Nicor is directed to file tariffs that reflect these conclusions for Rates 6 and 76.

With regard to Rate 7 and Rate 77, much of the disagreement among the parties reflects their differences regarding the appropriate cost of service study. The record indicates, with certain conditions, Nicor does not object to either Staff's method for determining charges or IIEC's method of determining customer or demand charges, in the event the Commission decides to base the charges on an embedded cost of service study to determine revenue allocations. The Commission has already resolved that issue above. Along with a determination that Nicor's marginal cost of service study would play little if any role in the rates established in this proceeding.

For purposes of this proceeding, the Commission directs Nicor to recalculate its embedded cost of service study, consistent with the other findings in this Order, and to set the customer charge for Rate 7 and Rate 77 at the level consistent with the results of that study. Again, the customer charge for Rate 7 should be $25 per month lower than for Rate 77 for the reasons discussed above. Likewise, the Commission finds the demand charges for Rates 7 and 77 should be identical and reflect the results of the new cost of service study discussed above. The Commission rejects IIEC's proposal to establish a seasonal volumetric or distribution charge. In the Commission's view, the record simply does not support adopting this proposal at this time. Instead, the same volumetric charge for both Rates 7 and 77 should be set on a residual basis to recover the combined class revenue requirement responsibility. Nicor is directed to file tariffs for Rate 7 and Rate 77 that reflect these conclusions.

Rates 5 and 75

BEAR proposed Rate 5 (Seasonal Use Service) and Rate 75 (Seasonal Use Transportation Service) applicable to non-commercial, non-industrial grain dryers with minimal peak winter usage. The Company agreed to BEAR's proposal, and no other party contested the proposal. Accordingly, Rates 5 and 75 as proposed by BEAR are adopted.

Issues Specific to Rider 16 – Customer Select

Daily Delivery Algorithm

<u>Nicor</u>

Nicor describes Dominion's proposed daily deliver algorithm as a less desired alternative to full control over a portion of Nicor's on-system storage and upstream capacities, than the daily delivery obligation be dampened by removing the temperature factor from the models.

Nicor states that Staff witness Mr. Borden, while agreeing with Nicor's change in the tolerance level at month-end, suggests an additional change in the daily deliveries to Customer Select suppliers. Mr. Borden suggested that the level of withdrawals should change automatically with the weather on a daily basis. According to Nicor, Mr. Borden reported that this procedure, which came out of a collaborative process and is used for Peoples Gas' small volume Transportation customers, might work for Nicor's Customer Select program.

Nicor states that it has not proposed any tariff sheets that alter its existing algorithm, and therefore there are no tariff sheets currently suspended and before the Commission for decision on this issue. Nicor claims it is not appropriate to consider Mr. Borden's suggestion, absent proof that Nicor's currently filed tariff is unjust and unreasonable. Nicor states that the changes to the Peoples Gas tariffs came at the end of a collaborative process involving the utility and affected customers. Nicor avers that it has engaged in similar processes, including a process that led to changes to its Customer Select tariffs in advance of tariffs this past winter season. Nicor asserts that an important change such as the altering of the algorithm should only be done deliberately, and with the input of affected customers.

In Nicor's view, this is particularly true in light of the fact that the Peoples Gas program to which Mr. Borden cites has only about 12,000 customers, less than 5,000 of which are residential. Nicor claims its Customer Select program is much larger, both in number of customers and geographically. Nicor believes it should not be ordered to adopt a new scheme based on the record before the Commission in this Docket.

Staff

Staff states that Nicor currently provides no daily variability in storage withdrawals within a given month for Customer Select suppliers, despite the fact that Customer Select load is weather sensitive and varies daily based upon changes in the weather. Staff asserts that the inability to vary daily withdrawals from storage increases costs to Customer Select suppliers and is not indicative of how Nicor uses storage to serve Sales customers and other Transportation customers.

Staff proposes that Nicor provide greater flexibility in daily storage withdrawals for Customer Select suppliers by adopting a formulaic approach, similar to that approved for Peoples Gas' small volume transportation program, that will allow daily storage withdrawals to vary based upon forecast changes in heating degree days.

Staff asserts that its proposal provides greater flexibility to Customer Select suppliers, and is reflective of how storage should be used to meet peak demands and to provide a hedge against higher market prices for gas that are generally observed during the heating season. Staff claims its proposal is a gradual change from the existing storage withdrawal requirements imposed by Nicor because that proposal still provides a known daily amount to Nicor based upon the application of the formula to the respective Customer Select suppliers' loads.

Dominion proposes that Customer Select suppliers be provided greater flexibility in daily withdrawals from storage. According to Staff, Dominion's proposal allows Customer Select suppliers to withdraw gas from storage in a given month subject to storage inventory bandwidths that establish minimum storage inventory levels that must remain in storage for a given month in the heating season. Staff states that Dominion's minimum levels decrease as the heating season progresses, which reflects the actual operation of the storage fields. Staff adds that under Dominion's proposal, if a supplier's actual gas in storage on a given day or in a given month violates the minimum levels, then the supplier is penalized by a significant reduction (at least 25%) in its daily storage withdrawal capacity. That is, the supplier has significantly reduced access to storage gas if it violates these parameters and must meet its customer load through market purchases.

Staff supports Dominion's proposal and recommends that the Commission approve the Dominion proposal for Customer Select suppliers. Staff believes that the Dominion proposal for daily storage withdrawals is the long term solution to the problem of zero daily variability in storage withdrawals and is indicative of how the storage system is operated. However, Staff believes its original formulaic proposal is a more gradual move toward the Dominion proposal. If the Commission prefers a more gradual movement in providing greater flexibility in daily storage withdrawals for Customer Select suppliers, then Staff believes its proposal is superior to the Dominion proposal. Finally, Staff supports a collaborative process to provide greater flexibility in daily storage withdrawals for Customer Select suppliers should the Commission reject both Staff's and Dominion's proposals in this proceeding.

Dominion

As discussed elsewhere, Dominion has recommended that the Commission direct Nicor to provide Customer Select suppliers with control of their on-system storage, and assign to them a portion of Nicor's upstream storage capacity. Dominion states that if the Commission adopts these two recommendations, then there will be no need to adjust the daily delivery algorithm. Dominion argues that, if the Commission rejects these proposals, it should direct Nicor to adjust its daily delivery algorithm for Customer Select customers.

Under this alternative proposal, Dominion recommends that the daily delivery obligation be dampened by removing the temperature factor from the models. Dominion claims the result of this removal would be that the nominations of Customer Select suppliers would be more regular throughout the year than they are under the current rules. Dominion suggests that Nicor would then manage the imbalances between Customer Select deliveries and usage through its control of on-system and upstream storage capacity.

Dominion emphasizes that this is a secondary alternative to the proposals providing the Customer Select suppliers control of the storage facilities and the ability to use the on-system and upstream storage to dampen daily swings. Dominion argues that if Nicor expects Customer Select suppliers to meet daily usage swings, it should provide them with the resources to do so. Dominion contends that Customer Select customers pay the same as Sales customers for those resources and should have the same ability to use them. It is Dominion's position that if Nicor insists on maintaining control over on-system and upstream storage capacity, then Nicor should minimize the need for Customer Select to use those storage assets.

According to Dominion, even if Nicor is correct that the lack of suspended tariffs means the algorithm change cannot be made unless there is proof that Nicor's currently filed tariff is unjust and unreasonable, that standard has been met. Dominion states that Nicor's current algorithm is based on Customer Select customers being able to withdraw from storage the same amount each day in a month. Dominion claims that because Customer Select customers are primarily heat load customers, the weather sensitivity component of the delivery algorithm sharply increases and decreases their required deliveries in response to weather changes. Dominion asserts that this is contrary to the practice Nicor uses for its own Sales customers. According to Dominion, Nicor is able to keep its gas purchases relatively constant and withdraw more or less from storage depending upon the weather. Both Mr. Crist and Mr. Borden stated that if Nicor served its Sales customers the way it forces Customer Select suppliers to serve their customers, this Commission would find its actions to be imprudent. In Dominion's view, such a result is more than sufficient for a finding that Nicor's current tariff is not just and reasonable.

Dominion claims the Commission has already found that an identical tariff of Peoples Gas Light and Coke Company was not just and reasonable. In Docket 01-0740, the Commission rejected People's proposal that its Customer Select program have the same restrictions Nicor currently uses. Additionally, Dominion states that while Nicor argues that any changes to its tariff should be made using a collaborative process similar to that used in the case of Peoples, Nicor fails to note that the Peoples tariff was the direct result of a Commission Order in Docket 01-0740. Dominion also disagrees with Nicor's argument that it should not be required to use rules in place for Peoples, which has only 12,000 Customer Select customers.

Dominion suggests that the Commission should demand that Nicor do better than reject all other utilities' rules because of its claim that Nicor and its customers are unique. Dominion contends that since Nicor has failed to tell this Commission why it is unique and how proposed rules will not work in its service territory.

Commission Analysis and Conclusions

Staff agrees with Nicor's change in the tolerance level at month-end for Customer Select, but also recommends an additional change in the daily deliveries to Customer Select suppliers. Staff originally recommended that the level of withdrawals automatically change with the weather on a daily basis using a formulaic approach. Subsequently, Staff recommended adopting Dominion's proposal. Staff claims Dominion's proposal is the long term solution to the problem of zero daily variability in storage withdrawals and is indicative of how the storage system is operated. Staff believes its original formulaic proposal is a more gradual move toward the Dominion proposal.

Dominion proposes to allow Customer Select suppliers to withdraw gas from storage in a given month, subject to storage inventory bandwidths that establish minimum storage inventory levels that must remain in storage for a given month in the heating season. Under Dominion's proposal, minimum levels decrease as the heating season progresses. If a supplier's actual gas in storage on a given day or in a given month violates the minimum levels, under Dominion's proposal, the supplier is penalized by a significant reduction in its daily storage withdrawal capacity.

As explained above, Nicor objects to both Staff's original proposal as well as Dominion's proposal. Among other things, Nicor argues that any change so important should only be done deliberately with the input of affected customers.

During any given month, Nicor's existing algorithm does not provide for any daily variability in storage withdrawals for Customer Select suppliers. As discussed in other section of this Order, this problem has been a source of frustration for Customer Select suppliers. Customer Select suppliers have complained that, compared to Sales customers, Customer Select customers receive inferior access to storage service. While it is necessary to recognize there are differences between Sales customers and Customer Select customers, the Commission believes there is clearly a disparity in the benefits that the two groups of customers derive from Nicor's storage assets under Nicor's existing tariffs.

The Commission also rejects Nicor's argument that this issue should be determined in the future. If Nicor truly believes this is an important issue, it should have addressed the merits of Staff's and Dominion's proposals rather than simply suggesting that affected customers may wish to have input. The Commission is of the opinion that important issues deserve prompt attention rather than delay.

Having reviewed the record, the Commission concludes that Nicor's existing algorithm relating to daily variability in storage supply results in undue discrimination against Customer Select customers relative to Sales customers and, therefore, Nicor's existing Customer Select tariff is not just and reasonable.

Of the two options available to address this problem, the Commission finds that Dominion's proposal is superior. While Staff's original weather based formulaic proposal would represent an improvement over the existing tariffs, it does not provide suppliers the level of flexibility or control that Dominion's proposal would provide.

Nicor is hereby directed to file revised tariffs for the Customer Select program that conform to Dominion's recommendations regarding daily control of on-system storage.

Monthly Balancing Tolerance/Penalty

Nicor

Nicor proposes to increase from 2% to 5% the tolerance level applicable at month-end to the variation between required deliveries for the month and actual deliveries nominated by the supplier. According to Nicor, Dominion proposes to eliminate entirely any monthly limitation on variance between required and actual deliveries. Nicor avers that this would result in a maximum month-end variance of 10% given the daily variation of 10% which would remain unchanged.

Nicor asserts that the current Customer Select program provides significant marketer discretion to vary on a daily basis from the daily nomination requirements, and would get greater flexibility from the proposed increase in the month-end tolerance.

Nicor avers that under its proposal, while a supplier cannot under-deliver at the maximum limit for every single day of the month, a supplier could under-deliver at the maximum level for at least 15 days without a penalty. In Nicor's view, that is reasonable, providing flexibility without abuse.

Staff

Staff supports Nicor's proposal to increase end of the month tolerances for daily deliveries from 2% to 5%.

Dominion

Dominion proposes to eliminate the month-end tolerance because, in Dominion's view, it provides minimal benefit to Nicor and is costly to suppliers and is an unnecessary duplicative penalty. Dominion argues that this month end requirement is unnecessary because the Customer Select supplier must deliver gas to meet "daily" customer usage targets. Dominion claims that while the month-end tolerance requirement has the effect of canceling out the benefits of the daily tolerance band allowed by Nicor, the most significant impact on Customer Select suppliers is the potential for second penalty when a supplier meets all of the daily delivery requirements of Nicor.

Dominion contends that Customer Select suppliers cannot nominate gas at one end of the daily band for more than a few days without risking a month end penalty or reducing end of the month nomination flexibility. Dominion argues that the month-end tolerance is a rule imposed by Nicor that takes away from Customer Select customers the storage that they are paying for in their rates and that makes their storage usage rights inferior to those of Sales customers.

Dominion asserts that a month-end delivery tolerance imposes a stricter requirement on Customer Select customers than on Transportation customers, who have neither a daily delivery nor a month-end delivery tolerance. It is Dominion's position that the Transportation class uses 4.6 times as much gas annually as Customer Select customers. Dominion argues that if Nicor is able to maintain system reliability and storage field functionality without imposing daily delivery and month-end tolerances on customers using 1,747,816,000 therms of gas annually, it should be able to do the same without imposing additional restrictions on customers that use only 377,446,000 therms of gas annually.

Dominion also contends that Nicor does not need month-end delivery tolerance because it already has a 10% daily delivery tolerance limit on Customer Select customers. Dominion states that even if a Customer Select supplier nominated at the top end of its daily tolerance every day of the month, it would still only exceed the monthly allowed delivery by 10%. Dominion argues that the daily tolerance provides Nicor with significant protection against under or over deliveries. Dominion claims this is another limitation that is not imposed on Transportation customers and the only tolerance that the two classes share is the month-end cash out provision. Nicor compares monthly billed volumes to the regular daily deliveries and storage changes; if the difference exceeds the acceptable range, then the supplier is cashed out for the difference.

In Dominion's view, imposing the month-end tolerance on Customer Select, which already has two other tolerance checks, is duplicative and discriminatory, while providing marginal benefits to Nicor. Dominion maintains that it imposes significant cost exposure on Customer Select customers and Dominion proposes that it be eliminated.

In its reply brief, Dominion disputes Nicor's claim that its existing rules provide significant flexibility because a supplier could over or under deliver at the maximum level for at least 15 days without a penalty. Dominion argues that no provider could ever do that, because it would then be forced to over or under deliver a significant amount the rest of the month in order to achieve the month-end variance target.

According to Dominion, while the extreme examples that Nicor and Dominion have provided demonstrate some aspects of both company's proposals, they do not illustrate the dilemma that Nicor's month-end tolerance imposes on Customer Select providers in real life. Dominion states that from the first day of the month, the month-end tolerance hangs over all decision-making, with each passing day reducing the time left to bring deliveries within the required level. Dominion asserts that providers know that every time their daily nomination adds to their month-end deficiency/surplus, they reduce their flexibility toward the end of the month. Dominion contends that as a result, the primary impact of Nicor's month-end tolerance is that it forces providers to make uneconomic decisions, such as declining inexpensive gas for fear that a better opportunity may come along later in the month, or purchasing very expensive gas for fear that the need to fit within the month-end tolerance may force the purchase of even more expensive gas later in the month. Dominion argues that these are decisions that Transportation customers and providers never face because they do not have the month-end tolerance. It is Dominion's position that if Nicor does not need the month-end tolerance for Transportation customers, it surely does not need it for the much smaller Customer Select program, particularly when Customer Select customers already must meet a 10% daily delivery tolerance that is also not required of Transportation customers.

RGS

RGS recommends that the Commission reject Nicor's proposed additional monthly tolerance penalty. RGS states that Nicor already provides monthly ratchets for storage and provides penalties for deliveries that fall outside the 10% daily tolerance. Given this, RGS believes the proposed additional monthly tolerance penalty is unnecessary, redundant, and unjustified.

RGS states that if Nicor requires a marketer to bring in 100 mcfs on a given day, and the marketer delivers 89 or 111, a penalty will be assessed for the insufficient or additional quantity. RGS argues that with daily and monthly injection and withdrawal ratchets, a marketer cannot consistently over or under deliver and remain within the ratchets. RGS asserts that if, for example, the Supplier delivers 10% in excess each day, it is likely that it is not going to remain within the monthly ratchet. RGS claims the converse is also true. Thus, reducing nominations below the daily 90% nomination tolerance would result in increased withdrawals beyond the monthly ratchet that also would create additional penalties.

In RGS' view, Nicor should not be permitted to unreasonably restrict Customer Select Suppliers' use of storage by imposing this proposed additional monthly tolerance penalty, but should instead adopt a balancing system that would allow Customer Select Suppliers to manage their supply similar to Transportation customers. RGS argues that, if Suppliers are permitted to use their pro rata share of storage on a daily basis, and deliver to a curve provided by Nicor within a daily tolerance, then there is no need for an additional monthly tolerance penalty.

It is RGS' position that Nicor has failed to explain why deliveries should be reduced to within 2% or 5% of required monthly deliveries by the end of the month, when it has demonstrated that it is fully able to manage the system on any given day with the 10% tolerance. RGS believes the monthly tolerance penalty should be eliminated. RGS asserts that even Nicor's proposal recognizes the need for an increase to at least 5%. RGS recommends that if the Commission concludes that any monthly tolerance at all is necessary, that tolerance should be set at no less than least 10%, consistent with the daily tolerance.

<u>Commission Analysis and Conclusions</u>

Nicor proposes to increase the tolerance level applicable at month-end to the variation between required deliveries for the month and actual deliveries nominated by Customer Select suppliers from 2% to 5%. Staff supports Nicor's proposed increase. Dominion and RGS propose to eliminate the monthly tolerance, arguing that the existing 10% daily tolerance is sufficient to meet Nicor's operating needs.

One of the difficulties in this proceeding is balancing the needs of Customer Select customers and suppliers for additional operating flexibility with Nicor's needs in operating the gas distribution system. While the Commission understands why Dominion and RGS wish to eliminate the monthly balancing tolerance and associated penalties, we are not prepared to do so at this time. At this time, the Commission believes that increasing the monthly tolerance level from 2% to 5% achieves the proper balance.

While the increase in monthly tolerance adopted here does not provide Customer Select suppliers with all of the flexibility they desire, it is clearly an improvement over the existing situation. Increasing flexibility for Customer Select suppliers can come at the cost of increase operating difficulties for Nicor and the Commission believes it is best to exercise caution under these circumstances. The Commission emphasizes that the conclusion reached here provides Customer Select suppliers more flexibility than what currently exists.

Access to Upstream Capacity/Elimination of Aggregation Balancing Service Charge

<u>Nicor</u>

According to Nicor, upstream capacity means the storage assets and transportation capacity on interstate pipelines for which Nicor has contracted to maintain flexibility. It currently uses the upstream capacity it leases on interstate pipelines for the benefit of all customers to operate the system and charges Customer Select suppliers a share of the cost of such contracts.

Nicor contends that it contracts for upstream capacity subject to FERC rules and upstream pipeline tariffs. The terms and conditions of those contracts are within the jurisdiction of the FERC, and it is not clear that the rights Dominion and RGS seek are within the power of the Commission to grant. According to Nicor, the FERC rules and FERC–jurisdictional interstate pipeline tariffs, which Nicor must follow, contain provisions that govern capacity releases (assignments), and generally restrict discriminatory releases.

Nicor claims that Dominion and RGS have not explained how the capacity releases they seek will square with FERC rules and FERC–jurisdictional interstate pipeline tariffs with which Nicor must comply. Nicor claims it relies on much of its upstream capacity, a portion of which is comprised of no-notice service, to manage the daily variation in sendout compared to the forecast for the entire system. Nicor maintains that reducing its control of those services for that purpose would have detrimental affects on its operations and increase its costs. In Nicor's view, the Commission should not order Nicor to begin releasing upstream capacity until it understands exactly how this will work, what costs it will involve, and who will bear those costs.

In Nicor's view, Dominion and RGS appear to be asking for preferential options to obtain certain rights of Nicor. Nicor asserts that Dominion and RGS do not explain how their proposals to give Customer Select suppliers an option on Nicor's leased capacity would satisfy these restrictions. It is Nicor's position that the Commission should not entertain these "sweeping" proposals to completely transform the Customer Select program without significantly more information, and without a demonstration that the rights transferred from Nicor to the Customer Select suppliers will not be illegal, or detrimental to other customer classes.

Dominion

Nicor requires Customer Select customers to pay a "Customer Select Balancing Charge" to cover the cost of providing them with upstream capacity. Dominion complains that Nicor does not allow Customer Select customers to use the upstream capacity that charge is meant to cover. Dominion claims Nicor neither allocates interstate pipeline storage to Customer Select nor allocates it firm transportation. Dominion recommends that Nicor assign on a pro-rata basis the associated upstream capacities based on the amount the supplier's customer group contributes toward the payment of such capacities on an annual basis.

Dominion argues that the allocation of upstream capacity is necessary in order for Customer Select suppliers to meet their requirements on cold days. Dominion states that although Nicor reduces Customer Select gas delivery requirements to 32% when it calls a critical day, critical days are rarely called. The more common occurrence is that Nicor will experience a cold, or even a peak day, yet not designate it as a critical day. Dominion asserts that on those days, Customer Select suppliers must be ready to meet all requirements – with no ability to adjust storage withdrawals. Dominion contends that Customer Select suppliers must incur the considerable expense of ensuring adequate supply of deliverable gas to meet the customer requirements in peak periods, not really knowing whether a critical day will be called or not. Dominion claims there have been cold days when Dominion was delivering to the citygate over 70% of its customer requirements, where none of the gas was delivered through the upstream capacity that Nicor charges under its Customer Select Balancing Charge, which demonstrates that it and its Customer Select customers benefit from Nicor's upstream capacity only on very rare occasion.

Dominion estimates that Nicor's Customer Select Balancing Charge adds approximately $0.20 per decatherm to the cost of gas for Customer Select customers with no corresponding benefit in supply flexibility on non-critical days. It is Dominion's position that first, and preferably, the Commission should direct Nicor to release storage capacity on one-year recallable basis and pipeline capacity on month-to-month recallable basis. Nicor would remain the contract entity and the capacity would be temporarily assigned to each Customer Select supplier. Under Dominion's proposal, Nicor would continue to pay the interstate pipelines and it could continue to charge its proposed Customer Select Balancing Charge. Dominion states that alternatively, Nicor could let the Customer Select supplier pay the pipeline demand charges and commodity usage charges, and then not charge the Customer Select Balancing Charge.

Dominion's proposal is based on its experience in several other states. Dominion avers that its proposed rules assign upstream capacity and storage based on a pro rata basis on what the customers contributed through the Customer Select Balancing Charge. Dominion states that during 2004, Customer Select represented approximately 13% of Nicor's total Sales and Customer Select billed monthly consumption. Under Dominion's proposal, it would be allocated 13% of Nicor's upstream capacity and storage. Dominion avers that it left the term length of the capacity release open so that Nicor can determine what works best for it.

According to Dominion, Nicor has the option in a critical day situation or in situations where the system operational integrity is compromised to order Customer Select suppliers to increase or decrease deliveries based on the circumstances. Dominions states that Suppliers that fail to deliver the needed volumes could lose their supplier aggregator status. Under Dominion's proposal, ultimately the capacity is recallable by Nicor at its discretion. Nicor can provide Customer Select suppliers a release on a segmented basis or on a non-segmented basis. Dominion contends that NGPL's capacity release tariff provisions allow the capacity DSS (delivered storage service) NSS (nominated storage service), and FT (firm transportation) to be released and that Dominion's proposed rules are consistent with their release program.

Dominion argues that the second and less preferable solution would be for the Commission to recognize that Customer Select customers should not have to pay for upstream capacity that they cannot use. Dominion asks the Commission to direct Nicor to remove the Customer Select Balancing charge from its tariffs. Dominion recognizes that Nicor may use upstream capacity to meet the needs of Customer Select customers on critical days. Dominion claims this obligation has provided minimal value, however, because Dominion never knows when a critical day may be called, so it must plan to meet supply needs on even the coldest days. Dominion therefore would rather not pay the Customer Select Balancing charge and be responsible for meeting its own supply needs during critical days.

Dominion disputes Nicor's assertion that it uses the upstream capacity for the benefit of all customers to operate the system effectively and efficiently. Dominon asserts that Customer Select customers' gas needs are met by the storage that they purchase and the gas they are required to deliver pursuant to Nicor's delivery algorithm. Dominion argues that the only possible benefit from upstream capacity that is provided to Customer Select customers is on the rare critical day, when Nicor reduces their delivery requirements. Dominion claims that even that benefit is minimal, because even on the coldest days of the year, Customer Select suppliers must be ready to deliver their full requirements in the event that Nicor decides not to call a critical day. Dominion is willing to give up the benefit of reduced critical day delivery requirements in return for access to upstream capacity.

Dominion also complains that rather than address the merits of Dominion's rules, Nicor hints that the Commission may not have jurisdiction to approve them and that they might violate FERC rules or interstate pipeline tariffs if they require discriminatory releases. Dominion avers that the Commission should reject Nicor's attempt to muddy the issue with unsupported contentions. According to Dominion, if Nicor truly believed the rules proposed by Dominion violate FERC rules or the tariffs of its interstate pipelines, it should have provided this Commission with clear examples. Dominion states that Nicor never placed any of these tariffs in the record, so no party could examine them to determine if violations would occur. Dominion also complains that Nicor failed to point out which FERC regulations are supposedly holding it back from allowing Customer Select customers from having access to the upstream capacity they are paying to receive.

According to Dominion, the entire linchpin of Nicor's argument is that providing Customer Select customers with access to upstream capacity is somehow a "discriminatory release" prohibited by tariffs and FERC rules. Dominion states that Nicor never explained how the Dominion proposal is a discriminatory release. Dominion claims Nicor never said one word about the details of Dominion's proposed rules.

Dominion suggests that at the very least, if the Commission accepts Nicor's arguments against providing Customer Select customers with access to storage, it should instruct Nicor to stop charging them for a service that they do not receive and to drop in its entirety the Aggregation Balancing Service Charge.

RGS

According to RGS, the Customer Select customer group should be given the benefit of the assets for which it pays; upstream capacity should be allocated on a pro rata basis and Customer Select customers should be allowed to elect an assignment of the upstream capacity. RGS claims that all base rate-paying customers pay for upstream assets and that Customer Select customers are not allowed to individually utilize their portion of the upstream assets for which they pay. In RGS' view, Customer Select customers' supply managers should have the same opportunity to optimize the asset they pay for that Sales customers do through their agent, Nicor.

RGS argues that both as the Tariffs currently exists and through the proposed changes to storage allocation, a significant inequity exists between how Sales versus Customer Select customers benefit from the storage and transportation assets they pay for. RGS contends that Nicor should not unduly discriminate in the way in which it assigns upstream assets.

RGS argues that if elected by a Customer Select Supplier with the assumption of the related costs, Nicor should be required to assign the upstream capacity and provide a pro rata reduction in the Customers' rates, based on the assignment. RGS contends that if, however, Customer Select Suppliers do not believe they can optimize the upstream assets more effectively than Nicor, those customers should continue to pay their full share of the charges.

Nicor has asserted that no one has specifically stated that they would want an assignment of upstream assets. According to RGS, given that RGS' customers currently pay for upstream assets and receive very little in exchange, several of the RGS customers would take an assignment of upstream assets in exchange for a one-to-one reduction in our customers' related rates. RGS asserts that the current and proposed Tariffs permit a Customer Select customer to directly reduce its costs by the level of firm transportation costs for which its Supplier is directly responsible. RGS claims that although the Customer Select customer pays for upstream firm transportation and storage through base rates, Nicor does not offer or permit assignment of that capacity to the customer's Supplier so the customer gets no use of these assets.

It is RGS' position that Nicor should be compelled to release capacity in compliance with FERC rules as is done by other LDCs in the U.S. and trued up through adjustment to the appropriate Select customer's rates. RGS suggests that Nicor would make the release on a recallable basis in order to protect against supplier defaults or a reduction in a given Customer Supplier's customer load. RGS claims that since the current Tariffs permit the proposed optional assignment of the upstream assets with a corresponding reduction of the rates but do not compel such an optional assignment, there is no reason to now compel Nicor to offer the option, unless Nicor is unwilling to voluntarily make a change without express direction from the Commission to do so. In RGS' view, making the clarification to the Tariffs so that a Supplier can take a recallable assignment, with a corresponding reduction in rates, is all that is necessary to resolve the upstream asset issue.

RGS also contends that, contrary to Nicor's suggestion, neither RGS nor Dominion is suggesting that an assignment should be discriminatory. RGS claims that it and Dominion have explained that Customer Select customers pay for upstream assets and yet do not receive their equitable allocation of the assets. In RGS' view, the FERC rules should not restrict the assignment of the upstream assets on a non-discriminatory basis. RGS maintains that the Commission should direct Nicor to develop a system that allows customers to utilize the on-system and upstream assets, without requiring a formal assignment of the assets to the Customer Select suppliers. RGS argues that the allocation and utilization of storage on a seasonal, monthly and daily basis must be equitable and Customer Select, Transportation and Sales customers must have the same rights with respect to storage assets in aggregate.

Commission Analysis and Conclusions

Dominion and RGS argue that Nicor should allocate to Customer Select customers a pro rata portion of Nicor's upstream capacity in return for the Customer Select Balancing Charge that is assessed to Customer Select customers. As an alternative, Dominion recommends eliminating the Customer Select Balancing Charge. Nicor objects to both of these proposals.

Dominion and RGS argue, in essence, that Customer Select customers receive almost no benefits from upstream capacity. Dominion asserts that Customer Select customers benefit from upstream capacity only on critical days. The record shows, however, that Nicor uses upstream capacity in a manner that benefits Customer Select customers, as a group, on many days. This occurs on any given day because the total amount of supply provided on behalf of Customer Select customers, pipeline resources combined with storage resources, will not likely equal the total amount of gas consumed by Customer Select customers. That is, when demand and supply are out of balance for Customer Select customers, Nicor uses upstream capacity to balance and maintain the operational integrity of the system. This balancing service benefits Customer Select customers as well as all other customers on the Nicor system. The discussion in the immediately preceding section of this order related to the Customer Select monthly balancing tolerances and penalties further demonstrates the nature of the balancing service Nicor provides to Customer Select customers. The Commission finds that Customer Select customers should be assessed a balancing charge for this balancing service provided by Nicor.

Because Nicor uses its upstream capacity, in part, to benefit Customer Select customers, the Commission is reluctant to require Nicor to allocate a portion of such capacity to Customer Select suppliers at this time. While it is not clear that Customer Select customers benefit from Nicor's upstream capacity to the same extent Sales customers do, it is clear that Customer Select customers benefit from those assets and should be assessed a Customer Select Balancing Charge. Thus, of the two proposed Customer Select Balancing Charges in the record, zero and Nicor's proposed charge, the Commission finds Nicor's proposed charge the most appropriate for purposes of this proceeding.

Finally, the Commission directs Nicor, in the prefiled testimony accompanying its next rate increase filing, to address the level of balancing charges Customer Select customers should be assessed in light of the benefits those customers receive from Nicor's upstream capacity. That testimony should contain a comparison of the benefits that Nicor's upstream capacity provides to Customer Select customers and Sales customers, as well as the associated levels of charges.

Billing and Gas Supply Administrative Costs

Nicor

Dominion proposes that Nicor include administrative costs, for billing and gas supplies, in the cost of gas instead of base rates. Nicor opposes this, arguing that Dominion merely seeks reconsideration of the Commission decision on this issue in Docket No. 00-0620. Nicor does not recommend any changes to Customer Select charges.

Dominion

Dominion claims that Nicor bills its Customer Select contingent twice for administrative charges associated with billing and gas supply. This is a result of Sales and Customer Select customers paying for such charges in base rates. Dominion contends that, in this manner, Customer Select customers subsidize Sales customers. Dominion asserts that the Commission should either remove such costs from the base rates or credit Customer Select Customers to compensate for the cross subsidy.

Dominion asks the Commission to reject Nicor's argument that due to the Commission having already addressed this issue in Docket 00-0620 the Commission is precluded from addressing this issue within the context of this proceeding. It contends that the previous docket is irrelevant.

Commission Analysis and Conclusion

The issue is whether to include billing and gas supply cost in base rates. Nicor maintains that such costs should be included in base rates, consistent with Docket 00-0620. Nicor notes that it has not made any changes to Customer Select charges after Docket 00-0620. The bald allegation of Dominion is insufficient to support a determination that a charge is not just and reasonable. Therefore, the Commission adopts Nicor's approach to include billing and gas supply administrative costs in rate base.

Mailing List

Nicor

Nicor opposes Dominion's proposal to provide a mailing list of Nicor customers to Customer Select providers. The Company first needs to verify that doing so does not create any privacy right violations. Further, Nicor asserts that this issue is irrelevant to the tariffs at issue in this case.

Dominion

Dominion argues that Nicor should provide their customer list to Customer Select customers. Dominion contends that only the customers' name and address would be including in the mailing list, eliminating any concern over privacy issues or other sensitive information. Providing a mailing list would expedite the registration process, minimize the chance of customer being switched to another supplier, and would act as another safeguard to ensure accurate information.

Commission Analysis and Conclusion

The Commission finds Dominion's argument unpersuasive. It did not assert any authority upon which it bases its request. Furthermore, Dominion is free to conduct its own marketing, and the Commission declines to order Nicor to provide the contact information of its customers to competitors.

Customer Select Signup (Account and Meter Numbers)

Nicor

Nicor opposes Dominion's proposal that Customer Select sign-ups not be required to provide account and meter number. Nicor argues the current system is superior, as the proposed change could lead to inadvertent switching.

Dominion

Dominion proposes that Customer Select sign-ups no longer be required to provide both account and meter number. Currently, both meter and account numbers are required in addition to the customers' name, address, telephone number and a tax identification number or social security number. Dominion contends this is too cumbersome. As a result, 2,423 customers have been precluded from Customer Select sign-up, despite having a valid account number. Dominion argues that Nicor is misleading when categorizing these occurrences as "verification error"; this implies that someone other than a customer attempted to switch suppliers, yet ignores the fact that a valid account number was provided. There is a presumption that requiring both account and meter numbers is a safeguard for the customer, but Nicor acknowledges having no complaints of slamming. Therefore, Dominion proposes that Customer Select sign-ups be only required to provide their account number.

Staff

Staff agrees with Dominion that requiring Customer Select sign-ups to provide both account and meter number is confusing to the customer. Staff contends that such confusion results in customers being unable to switch providers. Therefore, Staff supports Dominion's proposal requiring only an account number be required for Customer Select sign-ups.

Commission Analysis and Conclusion

At issue is whether Customer Select sign-ups should be required to provide both their account and meter number. Nicor argues that both should be required in order to safeguard against accidental switching. Dominion and Staff contend that this requirement is burdensome and is directly accountable for customers being preventing from switching gas suppliers. The Commission agrees, and finds that either an account number or a meter number, along with the remainder of the customer information, should be required for Customer Select sign-ups. Nicor acknowledges that slamming of customers has not been a problem. Therefore, the Commission accepts the proposal of Dominion and Staff requiring only the customer account number for Customer Select sign-ups.

Rider 13 – Group Size Limitations

Nicor

Nicor states that the current limitation on group size is imposed to maintain efficiency in administering billing and accounting functions at the group level. According to Nicor, suppliers frequently change the make-up of their groups as customers move into and out of groups. Since all customers in a group are billed at the same time, Nicor Gas argues that billing errors typically impact several different customers. In Nicor's opinion, expanding groups beyond 50 accounts increases the potential for billing errors for the group, and it increases administrative costs. Nicor states that although CNE provided examples of some other utilities which do not limit groups, CNE could not say how many Transportation customers these utilities had compared to Nicor.

Nicor opposes the suggestion by CNE and Vanguard that the limitation on group size for Rider 13 should be increased or eliminated. According to Nicor, Vanguard relies upon a tariff of Peoples Gas Light and Coke Company, which is attached to its brief. In Nicor's view, this provides an example of why tariff comparisons must be done with care; comparing just one portion of a tariff from one utility to another does not show the complete picture. Nicor states that the tariff cited by Vanguard indicates that Peoples allows groups of up to 150 Transportation customers and that the charge for that ability is $200 per month for a group, plus $10 per account in the group. For a group of fifty, Peoples charges the supplier $700 per month compared to Nicor's proposed charge of $35 per month. Nicor states that it is not twenty times more efficient than Peoples. According to Nicor, this tariff supports its assertion that administrative costs increase as groups expand above fifty.

CNE

CNE proposes that Nicor remove the current tariff restriction in Rider 13 that limits the size of each group to a maximum of 50 accounts. CNE states that since Nicor first introduced Rider 13 in April 1996, the transportation market has matured and CNE suggests that it should be up to marketers and their Transportation customers to determine what size group is appropriate for their needs; not simply potential administrative ease considerations on the part of Nicor. In CNE's view, absent a showing by Nicor that removing the 50-account group size limit would increase costs to non-Transportation customers, this restriction should be removed. CNE argues that Nicor has failed to make such a showing. CNE believes that if Nicor were able to show that removing this limit would cause Nicor to incur additional costs, which, it has not done in this proceeding, Nicor should be able to recover such costs through an appropriate cost-causer type of charge. CNE states that if such a charge is approved by the Commission, along with removal of the group size limit, the market will determine whether group sizes greater than 50 are desirable by marketers.

CNE claims that Nicor offered no formal study or analysis that showed that expanding group size would increase costs, increase billing errors or result in more confusion. CNE contends that these arguments are pure red-herrings to obscure the fact that Nicor's assertions are hollow and unsubstantiated.

According to CNE, many other utilities appear to be able to allow group sizes without limits, presumably without confusion and error. CNE states that Nicor's own tariff provides that changes occurring in a group during the course of a month can only be reflected as of the first of the following month. The larger the group size, the less likely a supplier will have the need to make changes.

Also, according to CNE, Nicor attempts to convince the Commission that its administrative costs will increase, by implying that Transportation customers want a service for which Sales customers will pay. In CNE's view, logic would suggest that by removing the limit of the size of a group would decrease the present number of groups, absent an unexpected influx of Rider 13-eligible customers. It argues, however, that removal of the cap on group size would actually save Nicor time and money compared to the current level of administrative costs incurred.

CNE believes that marketers and Transportation customers should determine for themselves what size group makes sense for their own needs. CNE suggests that Nicor should be neutral on this decision, only ensuring that Nicor recovers its costs for administering the Rider 13 pools, whatever group size each one is.

In its reply brief, CNE asserts that numerous utilities in the Midwestern region do not cap the number of accounts in a group, including two natural gas utilities regulated by the Commission – AmerenCIPS and AmerenUE. CNE presumes that these utilities have allowed groups without a size limit without confusion and error. CNE does not believe there should be any additional costs to Nicor from removing the group size limit. CNE states, however, that any costs associated with removing the size limit should be recovered through an appropriate, Commission-approved charge. According to CNE, the market then will determine whether group sizes greater than 50 are desired by marketers.

Vanguard

Vanguard argues that Nicor should be required to increase the number of accounts for each Non-Common Ownership Group ("NCOG") from the existing maximum of 50 accounts to 150 accounts, or in the alternative, to a minimum of 75 accounts. Vanguard claims that Nicor has been successful at implementing technological and productivity efficiencies with contract processing and group management since the last rate case, such as process time to add or delete Rider 13 group members. According to Vanguard, it is only natural that the 50 account minimum set in 1994 should expand in order to fully utilize these efficiencies.

Vanguard also argues that compared to prior years, there are presently fewer accounts on daily balanced transportation service rates. Vanguard asserts that an increase in accounts will not be overly burdensome for Nicor to manage, and indeed may simply raise the level of accounts on daily balanced transportation service rates to the numbers managed by Nicor in previous years.

Vanguard asserts that Nicor's daily balanced meters are consistently maintaining an extremely high call-in rate to the Nicor meter shop. Vanguard claims this high call-in rate translates to a minimal impact on delaying Nicor's billing, even if additional accounts are added.

Finally, Vanguard contends that Peoples Gas Light & Coke Company, has a maximum of 150 accounts for its transportation Pooling Service ("Rider P"). According to Vanguard, Rider SST mirrors Nicor's NCOG requirements regarding a daily read by a telemetry device and has been in service since the mid 1990's. It is Vanguard's position that Nicor should be able to increase the maximum number of accounts for each NCOG to 150, or in the alternative at least to 75.

Commission Analysis and Conclusions

Currently, the size of each group taking service under Rider 13 is limited to 50 accounts. Vanguard and CNE propose to increase the number of accounts and eliminate the limit altogether. Nicor argues that the current limit should be maintained, because a larger Rider 13 group size raises the possibility of increased billing errors and increased administrative costs.

In the Commission's view, eliminating the Rider 13 group size limitation, at some point, might be possible. The Commission finds that it is reasonable to increase the maximum number of accounts for each Rider 13 group to 150, as Vanguard recommends. This result provides a measure of relief to suppliers, while mitigating the possible impact of increased billing errors and increased administrative costs. The feasibility of further increasing the Rider 13 group size can be revisited in the future.

As for the possibility of increased administrative costs, if Nicor had presented evidence documenting the level of additional costs it alleges will occur as group sizes increase, the Commission might have had a sufficient basis for establishing an administrative fee. Unfortunately, the record does not contain sufficient information to establish an additional administrative fee.

Rider 6

Allocation of Hub Expenses through Revenue Requirement

Nicor

Nicor proposes that collected Hub gross revenues should be credited to Sales customers via Rider 6, but administration fees associated with these revenues be recovered as operating expenses through base rates. The "hub" refers to Nicor's transportation and storage facilities, utilized by Nicor to provide public utility service.

Nicor argues that Sales customers pay for costs associated with Nicor's purchased assets and the residual costs necessary to operate the system, so Sales customers should receive the credit. According to Nicor, it uses the bulk of its purchased assets for two purposes: (1) to supply gas for Sales customers, and (2) to support and operate the system or the benefit of all customers. Nicor also points out, however, that the associated costs are recovered from Sales customers, not Transportation customers. While Sales customers pay for all direct and incidental gas costs necessary to operate the system, Transportation customers operate within tariff provisions. Nicor surmises that, because Transportation customers receive the benefits of the expenditures made by the Sales customers, it is equitable to exclude Transportation customers from these benefits.

Nicor also argues that the current 120-day term limitation on Hub loans should be replaced with no time limitation in order to increase Hub revenue credits to PGA customers. Nicor further seeks to remove the one-year term limitation on other Hub transactions (excluding Hub loans) and replace it with no time limitation. Eliminating this limitation would increase the credit to PGA customers by increasing Nicor's business under its ICC jurisdictional tariff. Nicor initially argued that firm service should be offered via the Hub, but withdrew this proposal after opposition from Staff.

Staff

Staff is in agreement that collected Hub gross revenues should be credited to Sales customers via Rider 6, and that Hub administration expenses should be recovered through base rates. Staff, however, disagrees that Transportation customers should be excluded from these credits.

Staff states that the present method of crediting Hub revenues is to credit them against the base rate revenue requirement. Staff argues, however, that the present method gives Nicor an incentive to provide Hub services in a manner that may result in higher gas costs to Sales customers. According to Staff, this might occur under the present method because Nicor retains the revenues from Hub services (minus the fixed amount credited against the rate base revenue requirement) but any increased gas cost resulting from the provision of Hub services is recoverable from ratepayers. An incentive may exist under the present method for Nicor to enter into a greater number of Hub transactions and for larger amounts of money. Nicor could then retain all of the profit above the fixed amount credited to rate base. Staff argues that Nicor's proposal to credit Hub gross revenues to Sales customers via Rider 6 will provide greater protection for Sales customer against higher gas costs associated with Hub services. It will further provide a benefit to ratepayers commensurate with the provision of Hub services and thus be more equitable than the present method.

Staff also asserts that Transportation customers that utilize storage pay for storage facilities utilized for Hub services, and should thus benefit from Hub revenues. Staff proposes that the credits must include Transportation customers. Staff acknowledges that the vast majority of Transportation customers do not take service under Rider 6, and so would be excluded from the credit. Staff supports Nicor's proposal in surrebuttal to give a credit to Transportation customers via the PGA, assuming that such a proposal is feasible. Nicor would need to develop a proposal regarding this in order for the issue to be fully assessed.

Staff opposes Nicor's proposal to remove the present 120-day term limitation on Hub loan and replace it with no time limitation. Staff is concerned that removal of this limitation will result in higher costs to Sales customers, and asserts that the 120-day loan term limitation is a protection to Sales customers. For instances, if there are no term limits, Staff argues, Nicor may have an incentive to enter into Hub loans that compete with the use of system gas, and transportation and storage facilities intended for the Sales customers. This would increase costs to Sales customers.

Staff also opposes Nicor's proposal to remove the one-year term limitation on other Hub transactions (excluding Hub loans) and replace it with no time limitation. Staff argues that Nicor has failed to adequately explain how Hub transactions would increase under the ICC jurisdictional tariffs if the term limitation were eliminated. Staff argues that elimination of the term limitation may instead encourage Hub transactions that compete with the use of system gas, and transportation and storage facilities intended for the Sales customers. This would also increase costs to Sales customers. Staff opposed Nicor's proposal to offer firm service via the Hub, and Nicor subsequently withdrew this proposal.

IIEC

IIEC has objected to Nicor's proposal to credit collected Hub net revenues to customers via Rider 6, instead arguing that either the embedded cost of storage be reduced to reimburse Transportation customers, or a portion of these net revenues should be credited to Transportation customers via a rider which applies to all customers. IIEC argues that since Transportation customers do not purchase gas from Nicor, they have only negligible volumes pursuant to Rider 6.

IIEC argues that the testimony of Nicor witness Mr. Bartlett was contradicted by Mr. Bartlett himself. The purchased assets to which Mr. Bartlett referred in explaining why Sales customers should reap almost the entire credit were not in fact used to provide Hub services. IIEC argues that Hub services are instead provided from Nicor's owned storage fields and transmission assets. IIEC argues that both sales and Transportation customers support Nicor's storage system.

Nicor has suggested that the activities of Transportation customers somehow impose additional costs on Sales customers. IIEC argues that use of the distribution system by Transportation customers has absolutely no adverse impact on the cost of purchased gas for Sales customers, and, in fact, has reduced this cost for customers. IIEC also argues that the credits to Transportation customers could be provided via a separate rider, or through Rider 6 if feasible.

RGS

RGS also argues that Transportation customers should share in the disbursement of Hub net revenues. RGS, however, maintains that this credit should be made to all ratepayers through a reduction in base rates. According to RGS, Hub services are funded by base rates paid by all Sales, Transportation, and Select customers on a pro rata basis.

The two services provided by the Hub are park and loan services, which require two significant assets to operate: available online storage and pipeline capacity, and gas. RGS argues that available online storage and pipeline capacity and gas are paid for by all Nicor customers, not just Sales customers. Any benefits should then be shared with all Nicor customers.

RGS points out that Nicor witness Mr. Bartlett admitted that a significant portion of the assets utilized for HUB services are transportation assets. RGS argues that Nicor's gas storage facilities are filled with gas from Sales, Transportation, and Select customers, and there is no way to track which gas is being used for Hub services. RGS further argues that Sales, Transportation, and Select customers' unused storage space is used, in the aggregate, to offer Hub services.

RGS asserts that Nicor's ability to restrict the amount of storage allocated to Transportation and Select customers, the time at which these customers are permitted to inject into and withdraw from storage, and the utilization of storage. RGS argues that the result of Nicor's restrictions is that additional assets used to provide Hub services are made available. According to RGS, these restrictions, and any additional restrictions imposed based on Nicor's proposed changes to its tariffs, make it inequitable for Nicor to deprive Transportation and Select customers of the credit available from Hub services.

RGS argues that while Nicor charges all Sales, Transportation, and Select customers through base rates for expenses related to Hub services, Transportation and Select customers do not receive any benefits from this charge. In fact, transportation and select suppliers must pay a fee when they utilize Hub services. RGS concludes that since all customers pay for expenses related to Hub services, all customers should receive the benefit from these services.

RGS also maintains that it would be appropriate if Nicor credited its Transportation customers via a rider, as suggested by Staff. RGS believes that Rider 6 could be used to provide this credit to Sales customers, and another rider could provide this credit to Transportation customers. In this manner, each group could be credited a proportional amount to the amount it invested in Hub services.

Commission Analysis and Conclusion

Nicor proposes that collected Hub gross revenues should be credited to Sales customers via Rider 6. Nicor further proposes that administration fees associated with these revenues, forecast as $1,079,000 in 2005, should be recovered as operating expenses through base rates. No other party agrees with Nicor. Staff, IIEC, and RGS, on the other hand, all are of the opinion that providing this credit only to Sales customers would be inequitable. Staff, IIEC, and RGS instead argue that these credits should be made to all Nicor customers, as all Nicor customers pay the expenses associated with Hub services.

While Nicor argues that Sales customers pay for costs associated with Nicor's purchased assets and the residual costs necessary to operate the Hub system, the other parties have provided sufficient evidence to show that all customers pay the expenses necessary to operate the Hub services. The evidence has shown that all customers pay the expenses for the park and loan services provided by the Hub, and that all customers pay for the available online storage and pipeline capacity, and for the gas, which are necessary for the park and loan services provided by the Hub. The Commission finds that Nicor's proposal to provide the benefit of Hub services solely to

Sales customers would thus be inequitable. These benefits should instead be provided to all customers, including Sales, Transportation, and Select customers.

While RGS would like to see all customers credited via a reduction in rate base, Staff is concerned that this method gives Nicor an incentive to provide Hub services in a manner that may result in higher gas costs for Sales customers. Staff instead proposes giving the credit to Sales customers via Rider 6 and to Transportation customers via the PGA. Rider 6, however, does not provide service to the majority of Transportation customers. Nicor supports giving these credits to only Sales customers via Rider 6, but maintains that the Commission could provide a credit to all customers through the Gas Supply cost mechanism via the PGA. Delivery of the credits to Transportation customers via a separate rider would be equitable, or even via Rider 6 if modifications could make that possible. Staff has stated that it would be in support of Nicor's proposal to provide credits to all customers via the PGA if such a proposal were feasible. Staff argues that Nicor would have to develop a proposal to show the feasibility of providing the credits to Transportation customers in this manner. Ultimately, however, the Commission finds that there is no such rider in the record of this case.

The Commission also finds that Nicor's request to remove the 120-day term limitation on Hub loans and remove the one-year term limitation on other Hub transactions (excluding Hub loans) should not be granted. Nicor has not provided sufficient evidence to show that removal of these limitations would provide a benefit to customers, and Staff has presented arguments that removal of these limitations would instead be detrimental to customers in the form of higher sales costs.

Commodity Portion of Uncollectibles

<u>Nicor</u>

Nicor argues that it should recover commodity-related uncollectibles expense in Rider 6, subject to the partial offset relating to collected Hub revenues discussed above. Nicor has performed a statistical analysis to separate commodity-related uncollectibles expense from other uncollectibles expense. Nicor has computed the commodity-related uncollectibles expense as a consistent 66.6% of the total uncollectibles expense. The purchased gas adjustment (PGA) clause provided for in Rider 6 is based on Section 9-220 of the Public Utilities Act, which states that the Commission shall initiate annual public hearings and "will reconcile any amounts collected" with the actual costs of fuel, power, gas, or coal transportation prudently purchased. (220 ILCS 5/9-220.) Nicor believes that the commodity-related uncollectibles expense can be separated from the remainder of uncollectibles expense and should be recovered using Rider 6. The remainder of uncollectibles expense would continue to be recovered through rate base.

Nicor argues that including its commodity-related uncollectibles expense in Rider 6 would improve the accuracy of the PGA reconciliation because it would provide a more accurate determination of Nicor's actual costs and amounts collected relating to the cost of gas. Nicor further argues that including commodity-related uncollectibles expense in Rider 6 would be in the interest of Nicor's customers.

Nicor avers that it should not be required to purchase receivables for all Select and Transportation customers at zero discount, in the event the Commission finds that commodity-related uncollectibles expense should not be recovered via Rider 6. Nicor argues that its business is not debt-collection. According to Nicor, its commodity-related expenses are appropriately included in a PGA rider, rather than in rate base, given their amounts and volatility.

Staff

Staff argues that Rider 6 should *not* be used by Nicor to collect the commodity-related uncollectibles expense. Staff contends that the PGA exists to change charges based on variations in the cost of purchased gas. Staff argues that uncollectibles expense are not unrecovered costs of purchased gas, they are instead a cost of doing business which does not warrant special treatment through a rider. Staff argues that Nicor's interpretation of Section 9-220 of the Public Utilities Act and Part 525 in support of its position and its emphasis on the word "collected" is inconsistent with the manner in which this Act was interpreted in previous Commission decisions. The uncollectibles expense should therefore not be recovered through the PGA.

Staff presents an alternative argument that, if Nicor is allowed to split commodity-related uncollectibles expense from other uncollectibles expense, and recover one through the PGA and the other through rate base, the computed percentage of commodity-based uncollectibles recovered via Rider 6 should be reassessed on an annual basis, and should not remain a consistent 66.6%.

Staff avers that the portion of uncollectibles expense attributable to the gas commodity portion of the bill should not be recovered from Transportation customers. Staff reasons that all suppliers are already exposed to the risk of nonpayment and uncollectible expense. Staff argues that a requiring that Transportation customers pay for the uncollectible expense associated with the gas supply portion of the bill would mean that these customers would in effect pay twice. Staff argues that recovering uncollectibles expense attributable to the gas commodity portion of the bill from Transportation customers would therefore needlessly increase the cost for these suppliers. Instead, Staff argues that Transportation customers should only be allocated that portion of the uncollectibles expense attributable to the delivery portion of the bill.

Staff further points out that uncollectibles expense should be allocated based on therms, as therms are used by Nicor in its gas supply billings. Staff proposes that an analysis should be made considering the number of test year gas sales therms under each rate for the different customer classes. Staff argues that such a computation would result in recovery of uncollectibles expense from Nicor gas supply billings through the volumetric charge for sales billings under each rate. Transportation customers would pay less per therm distributed than would the Sales customers under the same rate or companion rate. The reduced volumetric rate for Transportation customers is based on Uncollectible Accounts Expense from gas supply billings divided by the combined total therms under the companion rates.

CUB/CCSAO

CUB/CCSAO argue that Nicor should *not* be allowed to collect uncollectibles expense via Rider 6, and that these expenses should instead continue to be recovered from rate base. CUB/CCSAO argue that Nicor uses its uncollectible reserve accruals, supplied by ratepayers, to make its ratemaking claim for uncollectibles expense, rather than using its actual net write-offs. CUB/CCSAO point out that Nicor's accruals have consistently exceeded its actual uncollectible expense. CUB/CCSAO argue that because the ratepayers fund the reserve accruals, the uncollectible reserve should be reflected as a reduction to rate base, and should not be collected via Rider 6.

CUB/CCSAO reject Nicor's proposed "uncollectible expense tracker" as single-issue ratemaking. CUB/CCSAO further argue that the purchased gas adjustment clause of Section 9-220 of the Public Utilities Act does not provide support for its argument to split commodity-related uncollectibles expense from other uncollectibles expense. CUB/CCSAO argue that costs, such as uncollectibles, which are a normal cost of the provision of service, do not warrant special recovery through a rider. CUB/CCSAO state that the gas cost portion of Nicor's uncollectibles is presently being recovered through base rates, as are all other uncollectibles expense, and this should not be changed.

Dominion

Dominion argues that Nicor's bad debts related to gas costs should not be collected from Customer Select customers. Dominion supports the goal of Sales customers paying for the bad debt incurred by that customer group and Customer Select customers being responsible for payment of bad debt incurred by that customer group.

RGS

RGS supports Nicor's proposal to recover commodity-related uncollectibles expense through Rider 6. RGS argues that this cost of gas expense is properly recovered via the PGA.

RGS argues that failure to include commodity-related uncollectibles expense in the PGA would have negative results, such as having Transportation customers subsidize Sales customers by essentially paying for an expense they are not involved in creating. RGS argues that allowing such a subsidy would artificially reduce the PGA and improperly allocate the expense. This would prevent customers from making fair and informed comparisons between the PGA and the competitive retail gas suppliers' offers. In essence, RGS argues that the customer would not be provided with accurate pricing information on which to make a purchase decision.

RGS also argues that if the Commission rules that the commodity-related portion of uncollectibles expense should not be included in Rider 6, Nicor should be required to purchase receivables for all Select and Transportation customers at zero discount. In this way, no customers would pay twice for the expense. RGS argues that the equitable result would be not to recover commodity-related uncollectibles expense from Select customers unless Nicor is purchasing the receivables from Select suppliers. In the alternative, if the Commission finds that commodity-related uncollectibles expense should not be included in Rider 6, and does not find that Nicor should purchase the Select and Transportation customers' receivables, it should provide for a credit to the Select and Transportation customers.

Commission Analysis and Conclusion

The Commission finds Staff's argument that commodity-related uncollectibles expense should not be included in Rider 6 persuasive. These expenses should instead continue to be collected through rate base.

The Commission agrees with CUB/CCSAO's analysis that Nicor's proposed "uncollectible expense tracker" should not be utilized. Commodity-related uncollectibles expense should not be split from other uncollectibles expense. The Commission agrees with Staff and CUB/CCSAO that costs, such as uncollectibles, which are a normal cost of the provision of service, do not warrant special recovery through a rider. Nicor has not met its burden of showing that these costs are of a nature that should be recovered through a rider rather than through rate base. The gas cost portion of Nicor's uncollectibles is presently being recovered through rate base and should continue to be recovered through rate base.

The Commission finds that inclusion of Transportation customers in the group from which recovery of uncollectibles expense attributable to the gas commodity portion of the bill is made is unfair to Transportation customers. Transportation customers are already exposed to the risk of nonpayment and uncollectible expense, and making them pay again for uncollectibles expense would be inequitable and simply operate to needlessly increase their costs. The Commission agrees with Staff's analysis that Transportation customers should only be allocated that portion of the uncollectibles expense attributable to the delivery portion of the bill. The Commission agrees with Staff that allocated uncollectibles expense should be determined based on therms. In this manner, Customer Select customers and Transportation customers would pay less per therm distributed than would Sales customers under the same rate or companion rate.

Given the above, the Commission disagrees that Nicor should have to purchase receivables for all Select and Transportation customers at zero discount, and finds that no separate credit should be given to this class of customers.

Commodity Portion of Gas Cost

See Commodity Portion of Uncollectibles section, above.

Gas Storage Losses

See Storage Gas Losses section, above.

Working Capital on Gas Storage

Nicor

Nicor agrees with Dominion to the extent that Customer Select customers should receive a credit for working capital on gas in storage, but Nicor maintains these customers already receive such a credit. Nicor argues that Customer Select customers already receive a credit for working capital on gas in storage as determined by the Commission in Docket Nos. 00-0620 and 00-0621, consolidated (January 3, 2002) (Order on Rehearing). Nicor states that as a result of these hearings, it has adjusted its administrative account charge from $1.03 to $0.59 to provide a credit of $0.44 per month per account to Customer Select customers for the gas storage inventory working capital. Nicor argues that if Customer Select customers were given an additional credit, this would amount to subsidy of Customer Select customers by retail customers.

Staff

Staff agrees with Nicor that Customer Select Customers should not receive any additional credit for the working capital on gas in storage.

Dominion

Dominion, a Customer Select supplier, argues that Customer Select customers should not pay for working capital on gas in storage because they do not use Nicor's gas in storage inventory. It argues that Customer Select customers should instead receive a credit because they presently pay for a portion of the working capital on gas in storage. As long as Nicor is giving this credit pursuant to the Commission orders cited, no further action needs to be taken in the instant proceeding.

Commission Analysis and Conclusion

As pointed out by Nicor, the Commission has previously ruled on the issue of credit to Customer Select customers for working capital on gas in storage in Docket Nos. 00-0620 and 00-0621. Since Customer Select customers are not presently paying for working capital on gas in storage, the allowance of a credit in this hearing would amount to a double-credit, given the rulings in Docket Nos. 0-0620 and 0-0621. Such a double-credit would not be favorable to retail customers, who would be paying for the extra credit. The Commission therefore rejects the proposal for the provision of an additional credit to Customer Select customers for working capital on gas in storage.

Elimination of Rate 81 – Energy Transportation

Nicor

Nicor seeks to eliminate Rate 81. Rate 81 is a special transportation and sale rate, on gas used as fuel for the production of electricity for customers or co-generation. Nicor claims it is a promotional rate that was designed to encourage natural gas use by on-site generators. The Company asserts that customers have been aware for approximately ten years that Nicor intended to phase out Rate 81.

Rat 81 is a subsidized rate that essentially discounted fixed costs. Nicor contends that, due to higher gas costs as well as stability and reliability of gas rates, this no longer makes sense. Currently, there are 32 active accounts under Rate 81 for which Nicor seeks to charge rates equal to customers who are similarly situated. Nicor maintains that, for those customers who will see an increase in charges, the average increase will only be 3.4%. According to Nicor, this marginal increase reflects increases in other rates and not the conversion from Rate 81.

CNE

CNE opposes the proposal to eliminate Rate 81. Participating customers made notable investments in the equipment necessary for implementation under Rate 81. Nicor now seeks to desert these customers and move them to a higher paying rate class. According to CNE, eliminating Rate 81 while simultaneously increasing rates exposes Rate 81 customers to two increases, approximately doubling their distribution costs. CNE argues that any elimination and transfer of Rate 81 customers should only occur when there is stability in the transferring class. This would facilitate in lessening the effects from such a transfer.

Commission Analysis and Conclusion

The issue is whether or not Nicor may eliminate Rate 81. Nicor contends that this is a promotional rate that has outlived its usefulness. Additionally, Nicor maintains that the rate increase Rate 81 customers face is nominal. The Company contends that customers have been aware of Nicor's intent to phase out the promotional aspects of Rate 81, to which CNE offers no response. The Commission grants Nicor's proposal to eliminate Rate 81.

Rate 21 – Interruptible Transport and Storage Service

Nicor

Hub services are a "collection of storage and transportation services that Nicor Gas provides Transportation customers, local distribution companies, and others, on an interruptible basis only." (Nicor Init. Br. 118.) Nicor has one of the largest hubs in the region, which provides a fluid market for trading gas supplies.

Nicor has proposed three changes to Rate 21. First it seeks to provide loans "as or as part of" intrastate transaction. Second, Nicor proposes the one-year maximum contract length and the 120-day limit on intrastate transactions removed. Finally, it seeks to offer a priority interruptible service. The Company claims that providing these changes allows for their intrastate Hub services to better mirror those available under their FERC tariffs. Furthermore, Nicor contends that concerns regarding transactions extending beyond 120 days and the one-year maximum contract length are unfounded. First, Nicor asserts, transactions longer than 120 days are currently permitted under Nicor Gas' FERC tariff. Second, a longer master contract does not mean that individual Hub transactions will be longer, and poses no additional risk to Nicor customers.

Staff

Staff asserts that removal of the term limitations on Hub services may encourage longer-term contracts, which in turn 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. Staff explains that Hub loans and services (and their master agreements) today may not be longer than 120 days and one year, respectively, in keeping with the short-term nature of the service. By removing these limitations, Hub loans and services likely will increase in term length and will compete with Sales customers for the use of facilities, which results in higher PGA costs for Sales customers. The Commission should maintain the current short-term nature of Hub transactions as a protection for public utility ratepayers.

Commission Analysis and Conclusion

Nicor states that it proposes to amend Rate 21 to: (1) allow for loans as, or as part of, intrastate transactions, (2) remove the current 120-day limit on intrastate transactions and no longer specify a one-year maximum contract length, and (3) permit it to offer "priority interruptible" services. According to Nicor, those changes will make Nicor's intrastate Hub services similar to those offered under the Company's FERC tariffs. The Commission finds that, when the first two proposed changes are taken together, the effect is that loans of indefinite length will be permitted if the changes are adopted. Before such an arrangement is approved, a more defined explanation of the parameters and safeguards in the proposal is required. Nicor also asserts that all of the proposed changes would make its intrastate tariff like its FERC tariffs. The Commission, however, is not clear *why* interstate terms and conditions are appropriate for intrastate transactions. Accordingly, Nicor's proposal is denied.

Rider 12

Nicor

Nicor proposed three changes regarding Rider 12: (1) to allow the recovery of research and development costs associated with environmental remediation; (2) to allow recovery of certain costs relating to "Manufactured Gas Operations" that the Commission has permitted to be recovered by other gas utilities with environmental cost recovery tariffs; and (3) to change the basis for the interest component from Nicor's after-tax cost of capital to the short term interest rate determined annually by the Commission. Staff agrees with Nicor as to setting the interest component, but urges rejection of the other two proposals.

According to Nicor, certain incremental research and development expenses fall within the purpose of Rider 12 and should be recoverable based on existing tariff language. Research and development costs associated with manufactured gas plants ("MGPs") appear to be within the scope of Rider 12 already. Nicor Gas' proposed revision would make clear that those and certain other research and development expenses are recoverable. Staff's position also should be rejected as being inconsistent with the Commission's decision granting MGPs cost recovery riders.

Nicor also proposes to add to Rider 12 the words "Manufactured Gas Operations" into the definition of "Environmental Activities." This change has the effect of giving Nicor comparable recovery of costs associated with MGPs, as has been allowed to other utilities. In comparing Nicor's MGP recovery rider with similar riders of other Illinois utilities, it appears that such other companies are able to recover costs relating to MGP operations that are other than remediation costs; Nicor Gas simply desires the same treatment.

Staff

Staff recommends that the Company's proposal to include recovery of research and development costs through Rider 12 be rejected for three reasons. First, research and development costs as incurred for remediation at a specific Nicor site have already been approved for recovery under the existing tariff language. Second, The USOA specifically addresses the accounting treatment of general research and development costs. Third, the Commission has previously ruled that general research and development costs, even though they may be related to environmental remediation, must be specific to the Company's MGP sites to be considered for recovery under an environmental rider.

For example, certain research and development costs have been recovered under Nicor's Rider but only after it was shown that the costs were incurred as part of remediation at a specific site, in the cited instance at Nicor's MGP site in Bloomington, Illinois. The costs were specific to the site and the Company was responsible to remediate it. Staff asserts that this is quite different from recovery of non-specific research and development costs related to MGP operations generally. The non-site-specific research and development costs which Nicor is attempting to recover through its rider are already recoverable through base rates. According to Staff, those non-site specific research and development costs fit within the definition of 32.B. of the USOA for Gas Utilities, which provides that the costs should be charged to Account.

Company witness Harms also claims that "The Commission granted utilities the ability to remove costs relating to MGP operations from base rates and allowed those costs to be recovered through a rider. Ms. Ebrey's position would not be consistent with the Commission's decision in granting MGP cost recovery riders." (Nicor Ex. 27B.0 at 9.) Staff counters that the Commission's Order in Docket 91-0080, which discusses recovery of "coal tar cleanup costs" and "coal tar remediation expense" (91-0080 at 63), is much more restrictive than "MGP operations."

Commission Analysis and Conclusion

Nicor's proposal to include research and development costs in Rider 12 is unsupported. The scope of Rider 12 is recovery of environmental remediation costs. (Rider 12, para. 1.) The Company contends that research and development costs need not be site-specific. The Commission, however, views environmental remediation operations as inherently site-specific in light of the various requirements for proper investigation, permitting, and review. The lack of site-specificity indicates to the Commission that the research and development at issue is of a general nature and not properly attributable to remediation. The Commission concurs with Staff that such general research and development activities should be excluded from Rider 12.

Nicor also seeks to insert the term "Manufactured Gas Operations" into Rider 12 to recover the cost of MGP operations as an environmental cost. Nicor's position is unsupported. It claims that its language mirrors that of other Illinois utilities. The

Company cites only one tariff, however, and its assertions are based on a misreading of the language contained therein. The Illinois Power tariff cited by Nicor explicitly limits its definition of environmental activities, and therefore recovery under its Rider, to investigation, removal, etc. of residues, byproducts, and remaining MGP plant:

> Environmental Activities refer to the investigation, sampling, monitoring, testing, removal, disposal, storage, remediation or other treatment of residues associated with Manufactured Gas Operations, or with other operations that generated substances subject to federal, state or local environmental laws conducted at locations where Manufactured Gas Plants operated, or the dismantling of facilities utilized in Manufactured Gas Operations.

(Nicor Ex. 27B.5 at 14.) The Commission finds no support for Nicor's position that MGP operations themselves should be recovered.

The Commission concurs that there is no contest as to the interest rate revision. The uncontested revision is accepted; the other two are rejected.

Riders 7 and 2 – Local Government Compensation Adjustment & Franchise Cost Adjustment

Nicor

Nicor initially proposed that Rider 7 allow recovery of all franchise and related costs imposed on the Company by a unit of local government, so that such costs are recovered from customers located within the boundaries of that local government, rather than from all customers through base rates. Rider 7, as originally proposed, would include annual reconciliations of costs and collections. Nicor contends that it maintains franchise agreements with 464 municipalities which grant the Company rights to operate within their communities in exchange for providing free gas to municipal buildings. In some cases, these franchise agreements require Nicor to provide municipalities monetary payments for the equivalent amount of gas. The initial Company proposal sought to recover costs on a per therm basis. In response to opposition from IIEC, Nicor revised its proposal to recover costs on a per customer basis.

In response to opposition by Staff related to the excessive number of potential Riders 7 which could require annual Commission reconciliation and adjustment, Nicor revised its proposal to limit Rider 7 exclusively to costs other than franchise fees which might be imposed upon the Company by local governmental bodies. Nicor argues that Rider 7 costs would be set through tariff filings if local governments impose non-franchise costs, and would become effective upon Commission approval. According to Nicor, the revised Rider 7 is equivalent of similar riders already in place for other utilities, such as ComEd Rider 28, to recover non-franchise fees imposed by municipalities.

Under its revised proposal, municipal franchise fees would be recovered in proposed Rider 2 (Franchise Cost Adjustment). Nicor proposed that Rider 2 would become effective January 1, 2007, and would remain unchanged until the next rate case.

According to Nicor, the proposed Rider 2 is the equivalent to similar riders already in place for electric utilities, such as ComEd Rider 16, to recover municipal franchise fees.

IIEC

IIEC opposed Nicor's initial proposal to recover on a per-therm basis franchise and non-franchise costs imposed by a local government from customers taking service in that municipality. IIEC contends that per-therm recovery is inconsistent with the concept of cost causation, and the costs in this instance have not been shown to be related to the volume of gas delivered. IIEC withdrew its opposition to Nicor's proposal following the Company's revision from per-therm to per-customer recovery.

Staff

Staff opposes Nicor's proposal, both in its original form and as revised. Staff argues that Nicor failed to explain how the proposal would affect general rates. Staff also notes that the costs Nicor proposes to recover, at $7.9 million, are approximately 0.4% of the test year revenue requirement. Staff contends that this amount is relatively insignificant compared to the administrative burden imposed by the potential for a large number of filings. Therefore, Staff argues that Nicor should continue to recover municipal franchise and non-franchise fees through base rates.

Commission Analysis and Conclusion

At issue is whether or not costs imposed by a particular, specific municipality should be borne by the Nicor customers residing within that municipality, or by all customers in general. Nicor proposed a methodology for ensuring that those costs are borne by the ratepayers within the municipality imposing them. The Commission concurs that costs imposed by specific municipalities should be borne by customers within that municipality, and not by other customers elsewhere in the service territory.

Staff's characterization of the amount at issue as insignificant is unavailing. Staff has sought adjustments to the test year revenue requirement in this docket for amounts far less than the alleged $7.9 million. Nor has Staff challenged Nicor's allegation that other utilities have similar riders in place. Furthermore, the Commission views Nicor's revised proposal to address Staff's concern as to administrative burden. Under the proposal as revised, non-franchise costs would be recovered under Rider 7, and franchise costs under Rider 2. Rider 2 would take effect on January 1, 2007, and would remain unchanged until the next rate case.

In light of the foregoing, the Commission adopts Nicor's revised proposal for Riders 7 and 2. To avoid the potential for a double recovery of these costs, the revenue requirement set herein shall not include any amounts to be recovered under Riders 7 or 2, notwithstanding the subsequent effective date selected by Nicor for Rider 2.

Rider 25 - Demand Gas Costs

No party in this proceeding disputed this charge. The Commission finds, therefore, that Nicor Gas' proposed charge for Rider 25 service is appropriate.

Energy Efficiency

Nicor

Nicor opposes the ELPC's request that the Commission order Nicor to invest $38 million per year, or alternatively, $10 million per year, in energy efficiency programs. CUB/CCSAO is in support of $10 million being adding to base rates as an operating expense.

Nicor does not oppose energy efficiency programs *per se*, but takes the position that careful planning is required before spending millions of ratepayer dollars to ensure the best possible program is developed in terms of both energy savings and cost effectiveness. Particular initiatives must be developed and their costs and benefits evaluated. The Commission also will have to consider how the initiatives will be implemented, administered, and evaluated for effectiveness.

Nicor also asserts that the record lacks sufficiently detailed information to determine the cost, rate design, and recovery mechanism, as well as the tariff language related to these points. While Dr. Kushler estimates that such programs would cost residential ratepayers about $10 per year, Nicor notes that this amount is derived by scaling a generic study. According to the Company, there has not yet been an analysis to determine what level of expenditure is appropriate with respect to either Nicor or Illinois. Nicor avers that a separate proceeding is appropriate to investigate these various considerations. For the purpose of the instant rate case, the Company avers that the proposals of ELPC and CUB/CCSAO should not be adopted.

ELPC

The ELPC has proposed that the Order in this case provide $38 million, or in the alternative a minimum of $10 million, in funding for energy efficiency programs. The ELPC recommends that the Company be allowed to recover the costs of the energy efficiency programs through its distribution rates as a normal operating expense. The ELPC argues that this ratemaking proceeding is the appropriate forum to address this issue because Nicor will be able to recover costs affiliated with the program. The ELPC opines that Nicor probably would not embrace an energy efficiency program outside the context of this proceeding, because they would be unable to recover the cost until their next rate case.

The ELPC contends that the General Assembly encourages programs of this nature. The ELPC cites the Public Utilities Act, which mandates "environmentally safe" power at "least-cost" for Illinois consumers and dictates the Commission's intention of "environmental quality." (*See* 220 ILCS 5/1-102.) An energy efficiency program accomplishes both of these mandates. According to the ELPC, the General Assembly endorses energy efficiency programs for the betterment of the people of the State of Illinois. (*See* 20 ILCS 687/6-2; 20 ILCS 1120/2(b)(1)&(2).)

The EPLC recommends that the Order in this rate case mandate that the energy efficiency programs include proven measures, such as incentives for efficient furnaces, water heaters, and windows, as well as weatherization measures. ELPC witness

Kushler testified that customers who participate in energy efficiency programs save money on their utility bills. The ELPC points out that frequently expensive gas is purchased at the margins, increasing the gas supply cost, and therefore the cost to consumers. The ELPC posits that the increased gas cost eventually depresses the economy. Nicor witness Jensen agreed that energy efficiency programs help eliminate the purchase of gas at the margins. The ELPC maintains that energy efficiency programs can help circumvent the purchase of expensive gas on the margin, to the benefit of consumers in lower gas bills and a stronger economy.

The ELPC argues that consumers benefit from a well-formulated energy efficiency program by a reduction in their gas bills. The ELPC notes that the American Council for an Energy Efficient Economy identifies 34 energy efficiency programs as outstanding; the ELPC asserts that those programs could serve as models for program in Illinois.

The ELPC also contends that energy efficiency programs could reduce Nicor's uncollectible expense. This benefit derives from a lower gas cost billed to consumers via Rider 6. The ELPC reasons that if the efficiency programs eliminate higher-priced gas purchased on the margin, the unit cost to consumers will also be lower, and, by extension, uncollectibles will also decrease. Conversely, the lower consumers' gas bills are, the more likely they will paid.

Finally, the ELPC opines that energy efficiency programs favor the Illinois economy by retaining more money within the State. ELPC notes that almost all of the natural gas consumed within Illinois is produced elsewhere. The ELPC argues that energy efficiency programs reduce the amount of natural gas consumed, and therefore reduce the amount spent on importing the commodity into Illinois. Conversely, at least part of the money spent implementing energy efficiency programs goes to workers in Illinois.

CUB/CCSAO

CUB/CCSAO endorse funding for the collaborative development of an energy efficiency program in the amount of $10 million per year. They agree with the ELPC's assertion that the rising price of natural gas has resulted in a financial drain for the State, and maintain that an energy efficiency program would result in a significant reduction in the demand for gas during peak months. CUB/CCSAO support the lower level of funding, however, to allow the efficiency measures to prove their value. CUB/CCSAO recommend workshops to develop clear goals and guidelines for efficiency initiatives and independent evaluation thereof.

Staff

Due to lack of detail, Staff does not support the proposal of the ELPC or CUB/CCSAO. Staff does support a collaborative process to develop energy efficiency programs and funding mechanisms.

IIEC

The IIEC opposes the ELPC and CUB/CCSAO proposals for funding of energy efficiency programs. The IIEC notes that $38 million is equivalent to half of the increase sought by Nicor, and its adoption would hit Rate 77 Transportation customers with a 45% increase, neglecting the base rate increase by Nicor. The IIEC contends that ELPC and CUB/CCSAO have requested $38 million and $10 million respectively for energy efficiency programs absent any proof that such programs would be cost-effective. According to IIEC, adopting an energy efficiency program in the amount of $38 million would increase energy costs by hundred of thousands of dollars for the large industrial customers that Nicor services.

Should the Commission choose to adopt such a program within the context of this proceeding, the IIEC requests that large industrial and manufacturing customers be exempt from any charges to fund efficiency measures. IIEC asserts that industrial customers have an economic incentive to pursue energy efficiency independent of a Commission mandate. IIEC contends that market prices have provided a sufficient incentive to pursue efficiency measures independently; according to IIEC witness Rosenburg, economic output per unit of energy has decreased by half over the last thirty years.

IIEC also raises two policy concerns with the proposals. First, energy efficiency measures are available in the competitive marketplace. Therefore, IIEC argues that there is no need to substitute regulation for competition. This particularly is the case for large industrial customers, for whom energy efficiency is most advantageous. Second, adoption of an energy efficiency program can result in cross-subsidization. Potentially, industrial customers who already invest in energy efficiency programs could be saddled with subsidizing energy efficiency funding for other rate classes. For all of these reasons, IIEC asserts that the ELPC and CUB/CCSAO proposals should be rejected. As proposed, large industrial customers would bear the economic brunt of such a proposal.

Commission Analysis and Conclusion

The ELPC recommends that the rate structure implemented in this case collect an additional $38 million beyond the Company's revenue requirement, or alternatively at least $10 million, to fund energy efficiency programs. CUB/CCSAO supports funding in the amount of $10 million. Nicor, along with Staff and the IIEC, advocate rejection of the proposals of ELPC and CUB/CCSAO at this time.

Nicor warns that, although such programs are intended to produce economic savings, this aim may never be reached without adequate planning. The Company maintains that, before ratepayer funds are collected, an appropriate program first must be designed and independently evaluated. Before such a program can be designed, the Commission needs to establish the polices governing the scope, implementation, and administration of such a program. Staff concurs with Nicor's concerns, and recommends that the Commission host a collaborative process to adopt such a program, so that the ideas and concerns of all interested parties can be heard and evaluated.

The EPLC made reasonable arguments for the adoption of energy efficiency funding, and the Commission believes that they should be considered in a forum for the development of particular guidelines for such programs. The Commission understands the importance of energy efficiency, and has begun to address other aspects of the issue in the Sustainable Energy Plan. (*See generally* 05-0437.)

The instant rate case, however, does not offer the appropriate forum to craft such a policy. The scope of a rate case is prescribed by Section 9-201 of the Public Utilities Act. (220 ILCS 5/9-201.) Parties other than Nicor frequently have cited Section 9-201(c), which places the burden on the Company to prove all aspects of the proposed rates are just and reasonable. The statute states:

> …the burden of proof to establish the justness and reasonableness of the proposed rates or other charges, classifications, contracts, practices, rules or regulations, in whole and in part, shall be upon the utility. No rate or other charge, classification, contract, practice, rule or regulation shall be found just and reasonable unless it is consistent with Sections of this Article.

(220 ILCS 5/9-201(c).) To mandate the collection of funds for an energy efficiency program in this Docket would require the Commission to find that Nicor has proven that an expense is just and reasonable, even though Nicor has not proposed it and does not support it in this rate case. The Commission finds such a construction is illogical. In essence, Section 9-201 of the Act limits the scope of the expenses considered in a rate case to those the utility proposes to recover. The Commission notes, however, that, by putting the recovery of an expense into issue, Section 9-201 does not prevent Staff or an intervener from proposing an adjustment or otherwise challenging it. Furthermore, nothing prevents a party, or the Commission on its own motion, from filing a separate case to resolve other issues such as the instant policy matter. By imposing the burden on the utility to prove the justness and reasonableness of all charges to be recovered in rates, however, Section 9-201(c) of the Act precludes other parties from suggesting additional expenses to be recovered in rates.

The ELPC alludes to certain findings of the General Assembly in Section 1-102 of the Act. The Commission concurs that the policies articulated in that Section are at the beginning of a thorough investigation into an appropriate energy efficiency program. The Commission agrees with Staff and Nicor, however, that a specific policy must be in place before ratepayers provide funding. (*Cf*. 220 ILCS 5/9-211 (requiring that plant be used and useful to be included in rate base and recovered in the revenue requirement).)

While these findings require that a collection of revenues for future energy efficiency programs be denied for the purpose of the instant rate case, this result should not be construed as a termination of the Commission's interest in the policy issue of energy efficiency. The Commission believes that the best approach is a collaborative process and rulemaking to codify the details of the programs to be implemented, as well as the methods by which they are funded. Such a process will better serve the public interest by adopting a statewide policy rather than a program unique to one utility. It also will promote transparency by ensuring that funding is collected only for programs which have been fully designed and approved.

VII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) Northern Illinois Gas Company, doing business as Nicor Gas Company, is an Illinois corporation engaged in the distribution and sale of natural gas to the public in Illinois and is a public utility as defined in Section 3-105 of the Public Utilities Act;

(2) the Commission has jurisdiction over the Company and the subject matter herein;

(3) the recitals of fact and conclusions of law reached in the prefatory portion of this Order are supported by the evidence of record, and are hereby adopted as findings of fact and conclusions of law; the Appendix attached hereto provides supporting calculations;

(4) the test year for the determination of the rates herein found to be just and reasonable should be the 12 months ending December 31, 2005; such test year is appropriate for purposes of this proceeding;

(5) for the test year ending December 31, 2005, and for the purposes of this proceeding, the Company's rate base is $1,270,316,000;

(6) a just and reasonable return which Nicor should be allowed to earn on its net original cost rate base is 8.90%; this rate of return incorporates a return on common equity of 10.59%;

(7) the rate of return set forth in Finding (6) results in base rate operating revenues of $558,822,000 and net annual operating income of $113,058,000 based on the test year approved herein;

(8) Nicor's rates which are presently in effect are insufficient to generate the operating income necessary to permit Nicor the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(9) the specific rates proposed by Nicor in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; Nicor's proposed rates should be permanently canceled and annulled consistent with the findings herein;

(10) Nicor should be authorized to place into effect tariff sheets designed to produce annual base rate revenues of $558,822,000, which represent an increase of $54,714,000 or 10.48%; such revenues will provide Nicor with an opportunity to earn the rate of return set forth in Finding (6) above; based on the record in this proceeding, this return is just and reasonable;

(11) the determinations regarding cost of service and rate design contained in the prefatory portion of this Order are reasonable for purposes of this proceeding; the tariffs filed by Nicor should incorporate the rates and rate design set forth and referred to herein; and

(12) new tariff sheets authorized to be filed by this Order should reflect an effective date not less than three (3) days after the date of filing, with the tariff sheets to be corrected, if necessary, within that time period.

IT IS THEREFORE ORDERED by the Illinois Commerce Commission that the tariff sheets presently in effect rendered by Northern Illinois Gas Company are hereby permanently canceled and annulled, effective at such time as the new tariff sheets approved herein become effective by virtue of this Order.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general rate increase, filed by Northern Illinois Gas Company on November 4, 2004, are permanently canceled and annulled.

IT IS FURTHER ORDERED that Northern Illinois Gas Company is authorized to file new tariff sheets with supporting workpapers in accordance with Findings (10), (11), and (12) of this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that any motions, petitions, objections, and other matters in this proceeding which remain unresolved are disposed of consistent with the conclusions herein.

IT IS FURTHER ORDERED that, subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

DATED:	August 17, 2005
BRIEFS ON EXCEPTIONS DUE:	August 26, 2005
REPLIES TO EXCEPTIONS DUE:	August 31, 2005

Thomas G. Aridas, Chief Administrative Law Judge
Ian D. Brodsky, Administrative Law Judge