STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Now comes the Staff of the Illinois Commerce Commission ("Staff"), by and through its undersigned attorneys, and pursuant to Section 200.830 of the Commission's Rules of Practice, 83 Ill. Adm. Code Section 200.830, respectfully submits this Brief on Exceptions to the Administrative Law Judges' ("ALJs") Proposed Order issued on August 17, 2005 ("Proposed Order" or "PO").

I. INTRODUCTION

For the most part, the Proposed Order accurately summarizes the positions of the parties and decides issues consistent with the facts and applicable law. However, there are several key issues for which the Proposed Order erroneously reaches an incorrect or improper result. As explained below, these erroneous or ill-advised conclusions should be revised. Additionally, Staff has identified some technical corrections that should be made to the Proposed Order.

II. Rate Base

B. Year-End or Average Rate Base Methodology

Staff disagrees with the PO's conclusion allowing Nicor to use a year-end rate base with a future test year. Staff continues to recommend its proposed adjustment to convert the Company's year-end rate base to an average rate base for the test year. Using an average rate base with the selected future test year would more accurately establish the Company's cost of service by more consistently matching the elements of the revenue requirement with one another in a forecasted, future test year that, by its very nature, is already forward looking.

<u>An Average Rate Base Should be Used with a Future Test Year</u>

The evidence shows that using an average rate base with a future test year is the appropriate policy. (ICC Staff Exhibit 10.0-Revised, pp. 10-15, ll. 190-280; pp. 20-21, ll. 397-406) When deciding whether to use an average rate base or a year-end rate base with a particular test year, the Commission should weigh two important but different and sometimes competing concerns against one another. On the one hand, a year-end rate base can be more forward looking. On the other hand, an average rate base more accurately reflects the cost of providing service for the test year because it better matches the level of rate base investment during the test year with the other costs incurred during that test year. An average rate base produces a more accurate result because it matches the components of the revenue requirement formula with one another in a consistent way for the test year. Thus, the Commission should weight the forward looking concern (represented by the Company's proposed year-end rate base) against the matching concern (represented by Staff's proposed average rate base) when deciding which rate base approach is best for the test year chosen by Nicor Gas in this case.

For this rate proceeding, Nicor Gas, which states that it is in a period of increasing investment, chose a forecasted, future test year that is based upon financial projections and, thus, is already forward looking. As a result, the Company's future test year already reflects its increasing investment. Therefore, in terms of weighing the two concerns, it is appropriate to give more weight to the matching concern than to the forward-looking concern since the test year chosen by Nicor is already forward looking. For this reason, the PO's conclusion is incorrect and Staff's proposed adjustment to use an average rate base for the test year should be accepted.

In addition, the Commission should also consider the flexibility it has given the Company regarding the timing of when new rates go into effect relative to the test year the Company chooses. The Company can use this flexibility to present a forward-looking case to the extent it chooses to do so. (ICC Staff Exhibit 10.0-Revised, p. 10, ll. 193-196)

A utility, in preparing a rate case, chooses (i) whether to propose a future or historical test year and (ii) when to file its rate case. The ability to choose both a future test year and the timing of when a rate case is filed, gives the Company flexibility in making its test year forward looking. In the current case, the Company chose both a 2005 future test year and a November 4, 2004 filing date.

Hypothetically, if the Company desired a test year that was more forward looking relative to the date on which its new rates would become effective, then it could have chosen a filing date earlier in 2004 or it could have chosen a filing date two months later and chosen a 2006 future test year rather than the 2005 future test year presented in this case. Presumably, the Company weighed its alternatives regarding the type of test year to use and the timing of its filing and made the choices it thought were best. The fact that the Company made the choices that it did, does not provide a sufficient reason to use a year-end rate base with the chosen future test year. (ICC Staff Exhibit 10.0-Revised, pp. 10-11, ll. 204-223)

The Company notes that if it had made its filing early in 2005, then the Commission's rules would permit the Company to reflect *pro forma* adjustments for plant additions through December 31, 2005. Mr. Struck agreed that this would be the case had the Company made that choice. (Tr. 978, ll. 10-18) However, what is more significant is that had the Company chosen a filing date in 2005, then the Company also could have chosen a 2006 future test year. (ICC Staff Exhibit 10.0-Revised, p. 11, ll. 215-219; Tr. 958, ll. 6-13) The Company's argument, rather than supporting the Company's use of a year-end rate base, merely highlights the flexibility the Commission has given utilities to make their test years and rate bases forward looking and how Nicor Gas has chosen to use that flexibility in this particular case.

In this case, the Commission should continue to follow its practice of using an average rate base with a future test year. Doing so will better match the level of rate base investment during the future test year with the revenues and expenses during the future test year, chosen by the Company, that is already forward looking. (ICC Staff Exhibit 10.0-Revised, p. 11, ll. 223-227)

The PO Fails to Consider the Forward-Looking Nature of the Company's Future Test Year

The PO concludes that, because the Company's projections reflect a rate base that increases during the test year, a year-end rate base should be used in order to prevent an under recovery of investment in net rate base. (PO, p. 8) However, in reaching this conclusion, the PO fails to consider the forward-looking nature of the forecasted, future test year chosen by the Company, which already reflects its increasing investment, or the benefits of matching the rate base during the test year with the revenues and expenses during the test year. The PO reflects these concerns in its summary of Staff's position, but omits any discussion or consideration of them in its analysis and conclusion. (See PO, pp. 7-8) The PO gives full weight to the forward looking concern and presents no discussion or analysis of the matching concern. The Commission should not find in favor of a year-end rate base simply because it is forward looking without first considering the extent to which the future test year is already forward looking. The PO reflects no such analysis.

The PO also fails to appreciate the logical extension of its conclusion. If an average rate base is inappropriate whenever rate base increases during the test year, then an average rate base would be appropriate only when rate base decreases during the test year. On that basis, an average rate base would be used only to shield a company from the effects of a declining rate base. The PO's conclusion would lead to the presumably unintended result of always choosing the rate base approach that is most favorable to a utility for the very reason that it is the approach most favorable to that utility without considering the nature of the test year chosen by the utility.

The PO not only fails to consider the forward looking nature of the Company's forecasted, future test year, the PO's analysis also betrays a misunderstanding of the basis for Staff's recommendation in at least two ways. First, the PO is incorrect when it asserts that Staff contends that Docket No. 90-0072 determined this issue. Second, the PO is also incorrect when it asserts that it is Staff's position that rate base is not increasing.

First, the PO states, "Staff also contends that Docket No. 90-0072 determined the issue." (PO, p. 7) However, it is not Staff's position that Docket No. 90-0072 determined this issue. Staff witness Struck clarified this in his rebuttal testimony where he stated:

> I agree that the Commission should base its decision in this Docket upon the evidence in this Docket. I indicated this to the Company in response to Nicor Data Request SAS-2.10.[1] My recommendation in this Docket is based upon the evidence in this Docket. It is not my position that prior Commission Orders preclude the Commission from reaching a different conclusion in this Docket. The basis for my recommendation is that an average rate base better matches the level of rate base investment with the revenues and expenses through out the test year than does a year-end rate base. That, coupled with the fact that the Company chose a future test year which is forward looking, leads me to recommend that the Commission use an average rate base in this proceeding. I refer to prior Commission orders to show that my recommendation and the basis for it are reasonable in that they are consistent with the Commission's prior practice. (ICC Staff Exhibit 10.0-Revised, pp. 19-20, ll. 381-393)

It is Staff's position that the decision in this case should be based upon the evidence in this case and that prior Commission Orders do not preclude the Commission from reaching a different conclusion in this case. Staff's testimony explicitly affirms this.

[1] ICC Staff Exhibit 10.0-Revised, Attachment B.

Second, the PO states that it "finds insufficient support for Staff's position that rate base is not increasing." (PO, p. 8) However, it is not Staff's position that rate base is "not increasing." Staff's recommendation is not based on such an understanding. What Staff stated is that the Company's history indicates that the Commission should not <u>automatically assume</u> that the Company's year-end rate base would be <u>more forward looking</u> than the average rate base. (ICC Staff Exhibit 10.0-Revised; pp. 10, 12-14; ll. 196-199, 228-242) Implicit in Staff witness Struck's calculation of the average rate base is the fact that rate base increased during the test year. (Staff Exhibit 10.0-Revised, Schedule 10.08-Revised) Staff witness Struck noted that the average rate base he proposed is lower than the year-end rate base the Company proposed. (ICC Staff Exhibit 10.0-Revised, pp. 6-7, ll. 120-121) Such a result is mathematically possible only if the rate base increased during the test year. Thus, Staff did not propose its adjustment based upon the belief that the Company's rate base decreased during the test year. Staff merely noted that the Company's rate base has decreased since the last rate case in order to caution the Commission against automatically assuming that a higher year-end rate base would be more forward looking in the long run.

More importantly, Staff's position explicitly assumes that the year-end rate base could be more forward looking than the average rate base. Staff witness Struck explained:

> Q. You indicated that even if the Company's year-end rate base were more forward looking than the average rate base, the Commission should weigh that against the benefit of matching the rate base to the operating revenues and expenses for the test year. Why is this so?
>
> A. When deciding whether to use an average rate base or a year-end rate base with a particular test year, one should weigh two

> important but different and sometimes competing concerns against one another. On the one hand, a year-end rate base can be more forward looking. On the other hand, an average rate base more accurately reflects the cost of providing service for the test year because it better matches the cost of capital for the rate base during the test year with the other costs incurred during the test year. A future test year is based on financial projections and therefore is already forward looking. Therefore, I believe it is appropriate to give more weight to the matching concern than to the forward looking concern in the case of a future test year. (ICC Staff Exhibit 10.0-Revised, p. 14, ll. 243-256)

Thus, it is not Staff's position that the Company's rate base has not increased during the test year or that the year-end rate base is not more forward looking than the average rate base. Staff's calculation of its adjustment shows that rate base increased during the test year. Also, Staff's position specifically contemplates that the year-end rate base could be more forward looking than the average rate base. Thus, when the PO rejects Staff's adjustment because it believes Staff's position is based upon the notions that Docket No. 90-0072 settled the issue and that the Company's rate base has not increased during the test year, it betrays a misunderstanding of Staff's proposal.

Finally, the PO gives considerable weight to the Company's incorrect assertion that Docket No. 90-0072 does not consider whether the utility in that case was in a period of increasing investment. The PO states:

> 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." (PO, p. 7)

However, the Commission's Order in Docket No. 90-0072 ("90-0072 Order") does consider whether the utility was in a period of increasing investment. In Docket No. 90-0072, Central Illinois Public Service Company ("CIPS") proposed a forecasted, future test year ending December 31, 1990. (90-0072 Order, p. 2) CIPS also proposed a year-end rate base as of December 31, 1990. (90-0072 Order, p. 2) The 90-0072 Order then proceeds to present both the year-end December 31, 1989 and year-end December 31, 1990 rate bases for CIPS. During the 1990 future test year, CIPS' rate base increased from $87,688,000 at December 31, 1989 to $89,982,000 at December 31, 1990. (90-0072 Order, p. 3.) The 90-0072 Order notes an argument presented by CIPS:

> CIPS submits that in the instant proceeding, an <u>end of year rate base as of December 31, 1990 is more representative of the rate base that will exist during the period in which the proposed rates will first be in effect</u>. CIPS cites testimony by Mr. Voss acknowledging that in historical test year proceedings, end of year rate bases are used because they <u>better reflect the rate base that will exist during the period when the rates will take effect.</u> (90-0072 Order, pp. 3-4) (Emphasis added)

Clearly, the Commission had before it the fact that CIPS' rate base increased during the 1990 future test year as well as the argument by CIPS that the year-end rate base would be more representative of the rate base that would exist during the period when the rates would first be in effect. The Commission considered these facts and arguments:

> 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 <u>CIPS has presented several well articulated arguments in support of its position</u>, the Commission agrees with Staff that an average rate base should be used. As suggested by Staff, an average rate base generally provides a better matching of test year rate base with operating revenues and expenses, and recent forecast test year rate proceedings have consistently used average rate bases. The Commission also notes that utilities which want to use more forward looking rate bases have the option of making rate filings based on more forward looking test years than those which correspond to the pendency of the proceeding. (90-0072 Order, p. 4) (Emphasis added)

The Commission not only considered the arguments presented by CIPS, but complemented CIPS on how well it had articulated them. Nicor Gas' argument that Docket No. 90-0072 does not consider whether the utility was in a period of increasing investment does not withstand scrutiny. It should not form the basis for rejecting the use of an average rate base with the future test year used in the current proceeding. As Staff witness Struck explained in his rebuttal testimony, the Commission's Order in Docket No. 90-0072 did not form the basis for Staff's recommendation. (ICC Staff Exhibit 10.0-Revised, pp. 19-20, ll. 381-393) Nevertheless, any attempt to distinguish the current case from Docket No. 90-0072 on the basis that rate base increased during the test year in the current case but did not do so in the test year in Docket No. 90-0072 fails.

For all the foregoing reasons, the PO's conclusion should be changed to accept Staff's proposed adjustment to convert the Company's year-end rate base to an average rate base for the test year. This would more accurately establish the Company's cost of service by more consistently matching the elements of the revenue requirement with one another in a forecasted, future test year that, by its very nature, is already forward looking.

Recommended Language

Staff recommends the following changes to page 7 and 8 of the PO:

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 notes that, in Docket No. 90-0072, the Commission found in favor of an average rate base based upon facts similar to those in this case. ~~also contends that Docket 90-0072 determined the issue, and~~ Staff contends 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. The Commission also finds that the Company's net plant balance has been increasing in recent years and that the total rate base increased during the test year. However, the Commission must also consider the nature of the test year chosen by the Company. The Company selected a forecasted, future test year that already reflects the Company's increasing investment on a forward-looking basis relative to when the Company filed its case. As Staff noted, the Commission gives utilities sufficient flexibility to make their rate cases forward looking. In light of the forward looking test year selected by the Company, the facts in this case do not support using a year-end rate base with that future test year. The average rate base proposed by Staff more accurately reflects the cost of service for the test year because it better matches the level of rate base during the test year with the revenues and expenses during the test year. The average rate base proposed by Staff is more appropriate than the year-end rate base proposed by the Company, given the future test year the Company selected. ~~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.~~

Alternative Argument

If, contrary to Staff's recommendation, it is determined that a year-end rate base should be used in this case, Staff recommends two changes to the PO's analysis. First, the PO should explain more fully why the forward looking concern should be given more weight than the matching concern in this particular case. This explanation is important because the PO's conclusion reflects a departure from the Commission's past practice. Second, the Commission should cite as a reason, something other than the mere fact that rate base increased during the test year.

Staff noted that in past cases, the type of test year chosen by the Company, historical or future, has consistently tipped the scale to one side or the other regarding rate base methodology. With historical test years, the Commission and Illinois utilities have consistently used year-end rate bases. With future test years, the Commission and Illinois utilities have consistently used average rate bases. Staff provided a list of 28 rate cases in which an average rate base was used with a future test year. Staff explained that it is not aware of a single case in which a year-end rate base was used with a future test year. (ICC Staff Exhibit 1.0, p. 8, ll. 151-173; ICC Staff Exhibit 10.0-Revised, pp. 15-16, ll. 276-304; ICC Staff Exhibit 10.0-Revised, Attachment A) Staff explained that this history does not form the basis for Staff's recommendation in this case. Staff refers to prior Commission orders to show that its recommendation and the basis for it are reasonable in that they are consistent with the Commission's prior practice. (ICC Staff Exhibit 10.0, pp. 19-20, ll. 381-393) However, given this history, the Commission should more fully explain why the type of test year chosen by the Company should be given less weight in this instance.

Second, the Commission should cite as a reason for using the year-end rate base, something other than the mere fact that rate base increased during the test year. First, as explained above, the Commission has been presented with this argument in Docket 90-0072 and has rejected it. Second, as explained above, such reasoning could be understood to mean that an average rate base should be used only with a declining rate base in order to shield a company from the effects of that declining rate base. Staff does not believe this is would be the Commission's intent in the long run.

C. Utility Plant Balance

Staff disagrees with the PO's conclusion that the adjustment to utility plant balance should not consider available data from 1998. (PO, p. 8) The PO agrees with Staff that it is appropriate to adjust the utility plant balance by computing a variance between actual and budgeted expenditures; however, the PO only considers the years 2000 through 2004. (PO, p. 11) Staff does not take exception to the use of 2004 actuals rather than only considering years up to 2003. However, the addition of the 2004 actuals to the 1998 to 2003 variance has no impact on Staff's recommended adjustment. The result would still be a -3.4% adjustment. Staff does disagree with the PO that it was arbitrary for Mr. Griffin to include the years 1998 and 1999 in his sample. Mr. Griffin stated in his rebuttal testimony that during his field audit and after discussions with the Company, he learned that 1998 was the first year that data was readily available to him to analyze. (ICC Staff Exhibit 13.0, p. 4) Mr. Griffin had no idea what the data for 1998 would show. For Mr. Griffin to completely disregard the information for 1998 because the variance was -17.5% would itself be arbitrary. By including a large number of years in the sample one can see the true variability of the data. Including all variances rather than just a few selected years as the PO has done would produce a more reasonable adjustment for ratemaking purposes. (ICC Staff Exhibit 13.9, p. 4)

Proposed Language Change

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%~~ Staff's 3.3% 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 randomly selected the period 1998 – 2003 as this was the information that was readily available. 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. The Commission disagrees. It is appropriate to consider all reasons for the variances. For the Commission to not consider the earliest year for which data was available would be arbitrary. The Commission finds that the appropriate years for this adjustment should be 1998- 2004. The record indicates that the variances for those years are -17.5%, -1.8%, -7.6%, +5.4%, -6.4%, +8.0% and -3.4%. As a result, the adjustment adopted by the Commission is a 3.3% reduction.

~~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.~~

III. Weather Normalization

A. The Commission Should Base Weather Normalization On Thirty Years of Data As It Has Done In The Past

Staff has fully set forth its view that the Commission should reject Nicor's proposal to use 10 years of data rather than 30 years of data to weather normalize billing determinants in its initial and reply briefs. (See Staff Initial Brief, pp. 54-57; Staff Reply Brief, pp. 39-48) Although Staff will not repeat those arguments here, a summary of Staff's key points is appropriate. Staff's position is based on the fact that the Commission has a long standing practice of using 30 years of data to weather normalize billing determinants for gas and electric utilities. Second, from a policy perspective, Staff believes that it would be inappropriate and dangerous to Illinois ratepayers and other utilities to depart from this practice without receiving input from all stakeholders and interested parties. Since such input has not been obtained or presented, such a departure should not be made in this docket.

When presented with alternative methodologies that impact rates, it is natural and understandable that there is an incentive for a utility to choose a methodology that maximizes its potential revenues. This revenue incentive is seldom used as the underlying basis to choose one methodology over another, but the existence of this incentive and its impact on a party's position cannot be denied. For this reason, and to ensure fairness to ratepayers and shareholders alike, it is very important that the Commission apply methodologies consistently among utilities. While Nicor offers ostensibly legitimate reasons for departing from use of 30 years of data to weather normalize billing determinants, the impact of the decision to use a new methodology on other utilities (and its resulting impact on ratepayers) should not be ignored. If the global and regional warming trend identified by Nicor justify the use of a shorter data period to weather normalize billing determinants, then the same determination should be made for any other utility subject to such warming trend. This is especially true for the temperature-based adjustments at issue here which run in opposite directions for electric and gas utilities (i.e., warmer weather means less demand for gas service, and therefore a higher cost per unit to recover costs, while warmer weather means increased demand for electric service, and therefore a lower cost per unit to recover costs). In short, the issue presented here provides a unique circumstance where a change from the existing practice should be made in an industry-wide (actually multiple-industry-wide) proceeding.

Moreover, the reasons presented in the PO for adopting Nicor's proposal are simply inappropriate. The PO's conclusion on the 10 versus 30 year issue is based on a very limited analysis. The first finding centers on the longstanding practice of the Commission and utilities to use 30 years of data to weather normalize billing determinants. The PO states that "Staff . . . 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." (PO, p. 56) This finding is contrary to the record, as Mr. Beyer clearly testified to the fact that this was the practice actually followed and Nicor nowhere contested that this was the practice. Indeed, Nicor witness Dr. Gordon specifically testified that "the Company is recommending a shift in long-standing Commission practice on this issue." (Nicor Gas Exhibit 2.0, p. 28)

The PO then goes on to indicate that "No analysis of HDD data has been provided to indicate that the ten-year period proposed by Nicor should not be used." (PO, p. 56) Although it is true that Staff did not offer testimony contrary to Nicor's testimony on the weather issue, it is inaccurate to view the record as one sided on this issue. Nicor's Exhibit 15.3 demonstrates that its 10-year proposal provided a more accurate result than the 30-year period in only 23 of 44 instances. (Nicor Exhibit 15.3) This fact clearly calls into question Nicor's proposal and provides a sufficient basis, when viewed in connection with Staff's other points, to reject Nicor's proposal in this docket. For these reasons, the PO's conclusions with respect to the appropriate weather normalization period should be rejected.

B. Proposed Language Changes

Consistent with the arguments presented above, the PO should be modified as follows:

On page 56, the next to last paragraph of the section entitled Commission Analysis and Conclusion should be modified as follows:

> 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. As discussed in the next paragraph, however, the Commission disagrees with Nicor's proposal in this case.

On page 56, the last paragraph of the section entitled Commission Analysis and Conclusion should be modified as follows:

> The second question is whether the ten-year weather normalization period sought by Nicor should be adopted. The Commission has reviewed the arguments, testimony, and exhibits in this case, and is not persuaded that it should revise its practice and now begin utilization of the 10-year weather normalization period. Staff presents convincing arguments for continuing to use ~~argues that the "practice" of~~ a thirty-year normalization period. It is appropriate for the Commission to consider the impact of a change in a long-standing practice upon Illinois' gas and electric companies. The effects of the climate changes discussed in Nicor's testimony are not limited to Nicor and its customers, and the Commission concludes that the same general approach should be applied to similarly situated utilities and their customers. The Commission does not want to establish a new policy for determining normal weather, heating degree days, and cooling degree days that encourages each utility to propose a

> weather normalization period that best suits its purposes. Additionally, the Commission has reviewed Nicor's Exhibit 15.3 in which the 10-year proposal provided a more accurate result than the 30-year period in only 23 of 44 instances. Those results do not support abandoning the 30-year period as the basis for determining heating degree days. Staff is directed to analyze the information gathered in response to its July 29, 2005 letter to parties seeking their input on this issue and to report the results to the Commission. A determination of next steps will be made at that time. ~~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-hear period proposed by Nicor should not be used. Accordingly, the ten-year weather normalization period is approved."~~

There are also several technical corrections that should be made to this section of the PO as follows:

On page 52, in the paragraph that begins, "Nicor asserts that the ten-year…", the word "earnings" in the third sentence should be "revenues".

On page 53, in the paragraph that begins, "Nicor views Staff to argue…", there is an incomplete sentence: "Nicor avers that a practice that is not a promulgated rule to trump the evidence in the record of a specific case." The sentence should probably read, "Nicor avers that a practice that is not a promulgated rule cannot ~~to~~ trump the evidence in the record of a specific case."

On page 53, in the paragraph that begins, "Nicor sees little need for…", there is a problem with the structure of this sentence: "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." The sentence should probably read, "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."

IV. Rate of Return

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

Staff disagrees with the PO's conclusion regarding the status of short-term debt in the Company's capital structure. The PO's decision to exclude all short-term debt from Nicor's capital structure (PO, page 69) is based on erroneous analyses and produces a higher rate of return on common equity than the ALJs' intended authorized rate of return on common equity. The PO's conclusion results in an upwardly biased rate of return that is not reflective of the company's actual capital structure.

The criteria for determining the appropriate treatment of Nicor's short-term debt in this proceeding was clearly articulated by Staff. (Staff IB, pp. 61-62). The Commission has determined that if short-term debt is supporting the utility's rate base, it must be included in the capital structure to accurately calculate the utility's cost of capital. (ICC Docket No. 02-0509, 2nd Notice Order, p. 22) Further, 83 Ill. Adm. Code 285.4010(a) states that the Commission will presume that short-term debt shall be included in the capital structure <u>unless the utility demonstrates otherwise</u>.[2] Thus, the burden of proof

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[2] The PO confusingly declares that "Part 285 is better characterized as procedural and administrative in nature, as opposed to substantive law that binds [the Commission] when deciding the issue of whether or not short-term debt should be included in Nicor's capital structure." (PO, p. 70) This declaration is wrong from two perspectives. While it might be true that <u>as a whole</u>, Part 285 sets forth filing requirements for utilities seeking to set rates, it also sets forth standards for determining some issues, such as short-term debt. 83 Ill. Adm. Code 285.4010(a) unequivocally states that the presumption is that short-term debt shall be included in a utility's capital structure unless that utility demonstrates otherwise. It is well established that

(continued…)

regarding whether short-term debt is properly excluded rests squarely on the Company. Contrary to the PO's determination (PO, p. 71), Nicor has failed to meet this burden.

The notion that the Company finances its rate base solely with long term capital is simply not supported by the evidence. To the contrary, record evidence points to the opposite conclusion. First, the Company's proposed rate base exceeds the long-term capital in its proposed capital structure by over $291 million. Thus, it cannot fund its rate base solely with the long-term capital in its recommended capital structure. (Nicor Gas Exhibit 20B.1; Nicor Gas Exhibit 41.0, p. 8) Second, as the Company itself admitted, other sources of funds the Company claims are used to finance the variable portion of Nicor Gas' rate base are insufficient to fully fund that portion. (Nicor Gas Exhibit 20B.0, pp. 27-28) Finally, the Company has provided absolutely no unbiased independent testimony that anyone, other than the Company itself, views rate base to be financed solely with long-term capital. In contrast, Staff showed, unequivocally, that rate base must be financed in part with short-term debt. Moreover, Staff presented evidence that Standard & Poor's ("S&P") also concluded that Nicor Gas uses short-term debt to finance a portion of its rate base. (Staff IB, p. 67)

The PO's finding on page 79 that "that the preponderance of record evidence shows that Nicor does not utilize short-term debt to finance rate base assets or make

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the Commission must follow its own rules. (Business & Professional People for the Public Interest v. Illinois Commerce Commission, 136 Ill. 2d 192 (1989)). Second, Staff never argued that 83 Ill. Adm. Code 285.4010(a) binds the Commission to a particular finding regarding the short-term debt/capital structure issue. Rather, Staff has consistently argued that 83 Ill. Adm. Code 285.4010(a) places the burden of proof on the utility, not other parties. The PO seems to accept that the utility has the burden of proof from a practical perspective. (See PO, pp. 70-71). Nevertheless, the PO's discussion of the legal implications of 83 Ill. Adm. Code 285.4010(a) at page 70 is erroneous and should be stricken from the Order.

long term investments in rate base" is particularly problematic in that it directly conflicts with Nicor's own admission in Docket No. 00-0620 that it finances working gas in storage exclusively with short-term debt.[3]

The PO provides little substantive argument in favor of excluding short-term debt from the capital structure. The PO does not address a single one of Staff's arguments that short-term debt is supporting Nicor's rate base. Rather, after summarizing the arguments made by the parties, it merely concludes (1) Nicor's short-term debt balance has been and is projected to be zero for a fraction of each year and (2) "no material changes [have occurred], whether factual <u>or legal</u>, in circumstances since Nicor's last rate case…" From those two propositions, the PO concludes that short-term debt is used "to meet the seasonal needs of running its gas operations." (<u>emphasis added</u>, PO, p. 71)

With regard to the first proposition, the Commission Order in Docket No. 95-0076 demonstrates that having a zero balance is simply an insufficient basis for excluding short-term debt from a utility's capital structure.[4] Unfortunately, the ALJs accepted the

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[3] Nicor Gas contends that the most reasonable way to calculate carrying cost savings on avoided gas storage inventory is to determine the actual incremental interest expense that it would avoid by shifting cost responsibility for injecting gas into storage to Customer Select suppliers. The Company asserts that its overall allowed cost of capital in its last rate case of 9.67% should be applied to the value of the 3 MDCQ days of storage that will be held year-round by Customer Select suppliers since this amount of storage is the reduction in the Company's long-term storage inventory needs. The Company contends that its short-term borrowing rate of 3.52% should be applied to the remaining storage inventory allocated to Customer Select because that inventory is fully cycled each year and, thus, is short-term in nature. <u>The Company asserts that its seasonal, cycled gas inventory purchases are and have always been financed through issuance of short-term debt</u>. (Order on Rehearing, Docket Nos. 00-0620/00-0621 (Consol.), January 3, 2002, p. 14. <u>emphasis added</u>).

[4] While Staff agrees that the utility in Docket No. 95-0076 used short-term debt for bridge

(continued…)

Company's faulty logic that Docket No. 95-0076 is not relevant to this docket because IAWC used short-term debt, not to meet seasonal cash needs, but as bridge financing, which was ultimately replaced with long-term capital. The Commission should not make the same mistake. It is true that because IAWC used short-term debt in a different manner than Nicor, the IAWC case should not inexorably lead the Commission to *include* short-term debt in Nicor's capital structure. However, the IAWC case does demonstrate that the *exclusion* of short-term debt cannot rest on the continuity of a short-term debt balance, or a lack thereof. Thus, the Company's implication that we are obligated to *exclude* short-term debt from the Company's capital structure merely because the Company forecasts no short-term debt for three months during the test period is erroneous. Consistent with its decision in Docket No. 95-0076 docket, 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)

With regard to the second proposition, Part 285 has been revised to clearly indicate a presumption in favor of including short-term debt in a utility's capital structure and places the burden of proving the opposite on the utility. Further, there have been

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financing, the case clearly demonstrates that whether short-term debt should be included in a utility's capital structure depends on how that utility uses short-term debt, not on whether any of the month-end balances of short-term debt were zero. Thus, the PO's discussion of the number of days that Nicor's balance of short-term debt was zero is insufficient for concluding that Nicor's short-term debt does not support rate base.

almost ten years of Commission decisions to include short-term debt in utility capital structures since the Order was issued in Docket No. 95-0219.[5] Finally, in Docket No. 00-0620/00-0621, the Company claimed that it uses short-term debt to finance working gas, which is a component of its current requested rate base. Thus, the PO's basis for excluding short-term debt from Nicor's capital structure rests upon spurious conclusions.

Finally, it is important to note that the PO's erroneous conclusion regarding short-term debt results in an apparently unintended, but significant, miscalculation of the Company's authorized return on common equity. In Docket No. 81-0609, the Commission recognized that a large divergence between rate base and the dollar amount of capitalization would prohibit the conclusion that there are no other sources of capital supporting rate base. In that proceeding, the Commission found that a 6.4% differential between capitalization and rate base was acceptable. (Order, Docket No.

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[5] See Docket Nos. 95-0534 (MidAmerican Energy gas rate case), 95-0641 (Consumers Illinois Water rate case), 96-0618 (United Cities Gas rate case), 97-0102 (Illinois-American Water rate case), 97-0254 (Northern Illinois Water rate case), 97-0351 (Consumers Illinois Water rate case), 98-0045 (Northern Hills Water & Sewer rate case), 98-0046 (Delmar Water rate case), 98-0047 (Great Northern Utilities rate case), 98-0048 (Lake Wildwood rate case), 98-0049 (Lake Marian Utilities rate case), 98-0298 (Illinois Gas rate case), 98-0545 (Central Illinois Public Service gas rate case), 98-0546 (Union Electric gas rate case), 98-0632 (Consumers Illinois Water rate case), 99-0121 (Central Illinois Public Service DST rate case), 99-0120 & 99-0134 Consol. (Illinois Power DST rate case), 99-0288 (Consumers Illinois Water rate case), (00-0337/00-0338/00-0339 Consol. (Consumers Illinois Water rate case), 01-0432 (Illinois Power DST rate case), 01-0444 (MidAmerican Energy DST rate case), 01-0696 (MidAmerican Energy gas rate case), 02-0690 (Illinois-American Water rate case), 02-0798/03-0008/03-0009 Consol. (Union Electric gas rate case), 03-0403 (Aqua Illinois Water rate case), 04-0442 (Aqua Illinois Water rate case), and 04-0475 (Illinois Gas rate case). Staff does not claim that this list of cases is dispositive of the short-term debt issue. Rather, this list of cases illustrates (1) that whenever a utility has outstanding short-term debt, including short-term debt in a utility's capital structure is the rule rather than the exception; and (2) the Commission's shift of presumption from *excluding* short-term debt in the capital structure to *including* short-term debt in the capital structure.

81-0609, July 1, 1982, p. 9). In contrast, there is a 10% differential between the PO capitalization and the PO rate base in this proceeding. Due to this large discrepancy, Nicor Gas would not receive a 10.59% return on common equity as the PO supposes (p. 93), but 11.70% as the table below shows. If the Commission does not intend that Nicor should be allowed an 11.70% cost of common equity, then it must include short-term debt in Nicor Gas' rate base.

ALJPO Implied Returns Calculation

Rate base	$ 1,270,316,000	PO, Appendix A, p. 1
WACC	8.90%	PO, p. 93
Operating Income	113,058,124	rate base * WACC; PO, Appendix A, p. 1
L-T interest expense	37,145,394	Nicor Gas Exhibit 36.1
Preferred stock div	73,824	Nicor Gas Exhibit 36.1
Net Income Avail. to Common	75,838,906	oper. inc. less l-t int. exp. and pref. stock div.
Recommended equity balance	648,156,000	Nicor Gas Exhibit 36.1
Implied ROE	**11.70%**	net income avail. to common / equity balance
Long-term debt	500,376,000	Nicor Gas Exhibit 36.1
Preferred stock	1,401,000	Nicor Gas Exhibit 36.1
Common equity	648,156,000	Nicor Gas Exhibit 36.1
Total capital	1,149,933,000	l-t debt + preferred stock + common equity
Rate base as a % of capital	110%	rate base / total capital
Implied return on total capital	**9.83%**	operating income / total capital

Proposed amendment. Based on the discussion above, Staff recommends that the language in the PO be amended as follows:

Page 61, third full paragraph

Staff

Staff witness Mr. McNally proposes to include 100% of Nicor Gas's net 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 forecasts 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. Therefore, contrary to the Company's claim that its proposed capital structure represents Nicor Gas' "actual" capital structure, the Company's proposal to exclude short-term debt in fact represents a deviation from its actual capital structure. Staff claims the Company has not met its burden to demonstrate why the Commission should adopt a capital structure that deviates from the Company's actual capital structure. (Staff IB, p. 61-62, 65; ICC Staff Exhibit 5.0, p. 4).

Page 64, third full paragraph:

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, in Docket No. 02-0509, a rule making to revise 83 Ill. Adm. Code Part 285 and the adoption of 83 Ill. Adm. Code 286 and 287, the issue of whether short term debt was to be included in the capital structure was addressed by the Commission. In that proceeding Staff argued, and the Commission concurred in its order, that the only valid reason to exclude short-term debt from a capital structure was if the utility demonstrated that short-term debt 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)). 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)).

Page 68, fifth full paragraph

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~~ included in 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.

The Company notes that ~~I~~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). However, regulatory policy is not static; it evolves with changes in economic theory and the accumulation of evidence over time. Nearly ten years has elapsed since that proceeding and it would be myopic to pretend that nothing has changed. As Staff has noted, an important development that cannot be overlooked is that the Commission has moved from presuming that short-term debt *does not* support rate base unless shown otherwise to presuming that short-term debt *does* support rate base unless shown otherwise. Since that proceeding, the Commission has noted, consistent with its 2003 revision to Part 285, that "[d]ue to the fungible nature of capital, it is generally assumed that all assets, including assets in rate base, are financed in proportion to total capital." (Order, Docket Nos. 02-0798/03-0008/03-0009, consol., October 22, 2003, p. 67). Thus, a utility would have to demonstrate that it does not use short-term debt to support its rate base, if short-term debt is to be excluded from its capital structure.

Prior Commission rulings are not binding in subsequent proceedings. Rather, each case is to be judged on the merits of the arguments of record in that case. Thus, the key determination on whether short-term debt is included or excluded from the capital structure in this proceeding is the *purpose* of the short-term debt, as evidenced by the record in the instant docket. 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 not. Nicor ~~explained~~ claimed that this debt is not used to provide a source of capital for long term assets~~.~~, but rather, that it uses short-term debt exclusively to finance non-rate base seasonal purchases. However, the Company's rate base is not composed entirely of long-term assets. Thus, even if Nicor does not use short-term debt to finance long-term assets, it does not necessarily follow that Nicor does not use short-term debt to finance a portion of its rate base. Further, while ~~N~~no party has disputed that Nicor's business, natural gas distribution, is seasonal in nature~~. —~~, there is also no disputing that seasonal business includes the purchase of natural gas for storage. The Company has included this gas in storage, a short-term asset that is forecast to vary by $331 million during 2005, in its requested rate base. The variable portion of Nicor's rate base must have a variable source of financing.[6] ~~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.~~ Thus, the Commission must determine, from the evidence presented, whether Nicor uses its short-term debt exclusively to finance non-rate based purchases, as the Company claims, or to finance, at least in part, rate based purchases, as Staff asserts. As noted previously, the burden falls on the Company to prove that short-term debt should be excluded from its capital structure.

Nicor ~~also~~ presented ~~persuasive~~ evidence demonstrating that its short-term debt is not used ~~intermittently~~ continually throughout the entire year.[7] Nicor contended that because it typically does not carry short-term debt balances year round, short-term debt cannot finance its rate base. However, the fact that Nicor does not maintain a short-term debt balance year-round merely suggests that the *year-round* portion of its rate base is not funded with short-term debt. However, as noted above, Nicor's rate base includes a *variable* component that requires a *variable* source of funding, such as short-term debt. ~~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.~~ Moreover, the Commission has ruled that sources of funding for rate base need not have continual, positive balances. As Staff noted, in Docket No. 95-0534 the Commission stated that "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). Further, in our Order in Docket No. 95-0076, the Commission included short-term debt in the capital structure for a utility that forecast no outstanding short-term debt for three months during the test period, just as

[6] Otherwise, Nicor Gas would experience large cash surpluses that run counter-seasonal to the gas in storage asset (i.e., increases in cash would be accompanied by a decline in rate base assets, such as gas in storage). Such is not the case.

[7] The record shows, however, that Nicor's use of short-term debt continues uninterrupted for approximately nine months of the year.

Nicor Gas has in the instant docket. Thus, the Commission's previous decisions clearly indicate that "permanency" in the sense of continual, positive balances, is not a prerequisite for including short-term debt in the capital structure. (Order, Docket 95-0076, December 20, 1995). The Company argues that Docket No. 95-0076 is not relevant to this docket because IAWC used short-term debt, not to meet seasonal cash needs but as bridge financing, which was ultimately replaced with long-term capital. We agree that because IAWC used short-term debt in a different manner than Nicor, the IAWC case does not inexorably lead us to *include* short-term debt in Nicor's capital structure. Nevertheless, the IAWC case demonstrates the exclusion of short-term debt cannot rest on the continuity of a short-term debt balance, or a lack thereof. Thus, the Company's implication that we are obligated to *exclude* short-term debt from the Company's capital structure merely because the Company forecasts no short-term debt for three months during the test period is erroneous. ~~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. The Commission finds that the preponderance of record evidence shows that Nicor has failed to meet its burden in this instance. We began our analysis by establishing that the key determination on whether short-term debt is included or excluded from the capital structure in this proceeding is the *purpose* of the short-term debt, as evidenced by the record in the instant docket. We further established that Nicor's rate base contains a variable component that requires a variable source of funding. Finally, we established that the continuity or lack thereof of a short-term debt balance is not a sufficient basis upon which to decide this issue. The Commission rejects the Company's unsupported argument that its short-term debt does not fund its rate base, as it rests on an arbitrary assignment of specific capital sources to specific uses, which is, in the Company's own words, "imprecise and fruitless." As a result, the Commission finds that short-term debt should be excluded from included in Nicor's capital structure in this proceeding.

We find that Nicor's capital structure should include $177,608,285 of short-term debt. The Commission rejects Nicor's argument that short-term debt should be limited to $36,625,000, which the Company claims to be the maximum amount that can be matched to rate base. Rather, we agree with Staff that any such attempt to match a portion of short-term debt to specific rate base assets would require a *comprehensive* matching of capital to uses, which Nicor has admitted is impossible. We further find Staff's proposal to include one hundred percent of Nicor Gas' net short-term debt, which assumes that all assets are financed by all sources of funds in proportion to total capital, to be reasonable.

B. Cost of Short-Term Debt

Proposed amendment. The following amendments to the PO's Cost of Short-Term Debt section are necessary to reflect the proper inclusion of short-term debt in Nicor's capital structure:

Page 73, first full paragraph

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. Thus, Staff recommends a 2.58% cost for Nicor's short-term debt, based on the February 7, 2005 discount rate on 60-day, AA non-financial commercial paper. (Staff Exhibit 5.0, pp. 12-13). Staff notes that this approach is consistent with the Schedule D-2 instructions and the approach Staff has followed and the Commission has accepted in numerous previous proceedings. (Staff RB, pp. 61-62).

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.

Page 74, second full paragraph

Commission Analysis and Conclusion

~~As t~~The Commission finds ~~that short-term debt should not be included in the capital structure, there is no further need to address~~ the allowable cost of ~~any such~~ short-term debt is 2.58%. We consider the cost of commitment fees related to short-term debt to be a reasonable component of the cost of short-term debt only if those commitment fees are shown to be reasonably incurred. Once again, the burden with respect to this issue rests on the Company. The Commission finds that the Company has failed in that regard. We find the Company's claims that such fees are reasonable and necessary do not constitute sufficient evidence thereof. We are particularly concerned that a proper allocation of the bank commitment fees among Nicor and Nicor, Inc. has not been established. Therefore, we cannot accept the Company's proposal. Further, we reject the Company's implication that the use of a time-weighed rate is required or preferable to the approach taken by Staff; no evidence has been presented to effect such a conclusion. Staff's approach is consistent with the approach adopted by the Commission numerous rate setting proceedings. For these reasons, we adopt Staff's proposed 2.58% cost of short-term debt.

C. Adjustments to Capital Structure Component Balances

Proposed amendment. The following amendments to the PO's Adjustments to Capital Structure Component Balances section are necessary to reflect the proper inclusion of short-term debt in Nicor's capital structure:

Page 74, third full paragraph:

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~~ claiming that 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~~ accepted Nicor Gas' proposed use of an end-of-~~test-~~year capital structure.~~ There is also no dispute concerning Nicor Gas' embedded cost of long-term debt.~~ Unlike the Company's proposal, Staff's long-term debt balance~~, however, does propose an~~ includes $18.6 million ~~deduction from the actual end-of-test-year book balance of long-term debt~~ of unamortized debt discount and expense for retired issues~~. Staff proposes this deduction on the basis that an adjustment is needed to account for certain retired debt~~. For purposes of consistency, Staff ~~has~~ maintains that unamortized debt discount and expense for retired issues should be reflected in Nicor's long-term debt *balance*, since both Staff and the Company included it in their long-term debt *cost* calculations. Staff notes that this approach is also consistent with the approach the Commission has accepted in numerous other rate cases. (Staff RB, p. 60).

Staff also reduced the long-term components of the capital structure by $7.9 million. Staff notes that the Commission's formula for calculating an AFUDC rate assumes that short-term debt is the first, but not necessarily only, source of funding for an AFUDC. That formula further assumes that any remaining CWIP not funded by short-term debt is funded by the Company's other sources of capital (i.e., long-term debt, preferred stock, and common equity) proportionally. Staff calculated that the Commission formula for calculating AFUDC assumes that those other sources of capital account for $7.9 million of CWIP accruing AFUDC. Thus, Staff removed $7.9 million proportionally the from the balances of long-term debt, preferred stock, and common equity~~ based on the average CWIP balance to account for its inclusion of short-term debt in the capital structure~~. (Staff IB, p. 68).

Page 74, sixth full paragraph

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. The Commission rejects the Company's argument that Staff's proposed $18.6 million deduction to the long-term debt balance to reflect residual unamortized debt discount and expense for retired issues is inappropriate. First, the Company's failure to contest this adjustment until its surrebuttal testimony did not allow for the development a complete record with regard to this issue. Second, as Staff noted, both parties reflected the residual unamortized debt discount and expense for retired issues in their long-term debt cost calculations. Thus, the Commission agrees with Staff that, for purposes of consistency, unamortized debt

> discount and expense for retired issues should be reflected in Nicor's long-term debt balance as well. Such an approach is consistent with the approach the Commission has historically adopted.
>
> We further find that additional adjustments to the long-term components of the capital structure are necessary for the same reason the Commission adopts the net, rather than the gross, short-term debt balance. That is, since the Commission's formula for calculating AFUDC assumes that any CWIP not funded by short-term debt is funded by the Company's other sources of capital proportionally, we must adjust those other capital components accordingly; failure to do so would result in a portion of the Company's capital being double counted, as it would be including it in both the AFUDC rate and in the WACC. Thus, we adopt Staff's capital structure, which consists of $177,608,285 (13.65%) short-term debt, $478,311,049 (36.77%) long-term debt, $1,386,101 (0.11%) preferred stock, and $643,607,150 (49.47%) common equity.

D. Cost of Equity

Staff disagrees with the PO's analysis and conclusion regarding cost of equity. Although the ALJs failed to recognize that Nicor's cost of common equity estimate is contrived and upwardly biased, the Commission should not make the same mistake. The PO's analysis and conclusion that Nicor's cost of equity analysis is superior to Staff's analysis (PO, p. 87) is essentially based upon two flawed findings. First, the PO places far too much emphasis on percentage of revenues from non-regulated business activities in evaluating a sample and fails to consider other relevant criteria in evaluating whether a sample is appropriate. (PO, p. 84). Second, the PO, without any reasoned basis, fails to address any of the critical errors and inconsistencies in Nicor witness Makholm's DCF and CAPM calculations, which Staff witness McNally exposed in his testimony. (PO, p. 85).

The PO erroneously finds that Nicor's sample is more representative than Staff's sample and therefore rejects Staff's sample. That faulty conclusion results from the

PO's flawed evaluation criteria which over-emphasizes the percentage of revenues from non-regulated business activities of the sample proxy. While Nicor and Staff disagreed over a number of issues regarding cost of equity, both Staff and Nicor did agree that it is total risk that drives a company's cost of capital (Nicor Gas Ex. 21.0, p. 29) and should ultimately be reflected in rates. (Staff RB, p. 64)[8] Because revenues do not capture financial risk (Staff IB, p. 85), the PO's complete reliance on percentage of revenues (i.e. a proxy for business risk, which is also referred to as operating risk) to evaluate a sample completely disregards the financial risk of the sample proxy. When one takes into account financial risk, which one must do, Mr. McNally's sample's average risk profile would be roughly the same as the modified McNally sample recommended by Dr. Makholm to "correct" Mr. McNally's analysis (i.e substituting KeySpan and Southwest Gas for AGL Resources, Peoples Energy, South Jersey Industries, and Laclede Group, which converts Mr. McNally's sample into Dr. Makholm's sample). As described in Mr. McNally's rebuttal testimony, the average credit rating would change from A to a slightly weaker A and the business profile would change from 2.75 to 2.5. (ICC Staff Ex. 14.0 corrected, pp. 20-21) Given the insignificant change in risk, Staff's sample should not be rejected in favor of an upwardly biased sample like Dr. Makholm's sample.[9] The focus by the ALJs on the business risk (i.e. percentage of revenues from gas

[8] In direct contradiction to its own witness, the Company made the incredible declaration that "Also inappropriate is Staff's use of not only business profiles, but also financial risks in determining its proxy group. The primary purpose of the proxy is to match business risks, not the financial ones." (Nicor Gas Reply Brief, p. 111) Such an outrageously incorrect pronouncement regarding a most basic financial tenet seriously undermines the Company's credibility.

[9] Staff did not accept that recommendation from Dr. Makholm since it would reduce the sample from eight to six which would increase measurement risk, as explained below.

distribution) rather than total risk (i.e., business risk and financial risk) clearly is a fundamental flaw which the Commission must not make itself.

The PO effectively adopts a minimum 80% percentage of revenues from utility operations in this docket, despite the fact that the Commission has accepted a cost of equity for a gas utility from a sample with a percentage of revenue from gas distribution as low as 42% in the past. (Staff IB, p.85 and Staff RB, p. 63) While the Commission is not subject to *res judicata*, the ALJs have departed from prior Commission practice in adopting a strict 80% percentage of revenues from utility operations criterion, which inexplicably fails to consider financial risk. Such a departure would subject the Commission's order to less deference on appeal should the Commission's order adopt the ALJs standard and said order is appealed. (Abbott Laboratories, Inc. v ICC, 289 Ill. App.3d 705, 715 (1997))

Further, the PO disregards the fact that even as a measure of operating risk, percentage of revenues from regulated operations is incomplete. (Staff IB, p. 85) The four previously mentioned companies (AGL Resources, Peoples Energy, South Jersey Industries, and Laclede Group), which Dr. Makholm recommended be dropped from Staff's sample and with which the PO took issue because the percentage of revenues from gas distribution for 2004 dropped below its 70% requirement, still had a substantial majority of their revenue from gas distribution, with the lowest percentage only going down to 61%. The PO fails to explain why a nine percentage point difference in revenues is so material that Staff's sample has to be rejected in its entirety, yet at the same time recognizes that Dr. Makholm's sample is significantly riskier than Nicor. (PO, p. 86) The 61% of revenues from gas distribution is well above the 42% the

Commission has accepted in the past, yet again the PO provides no rationale for adopting a rigid 80% requirement in this docket. In addition, the PO fails to consider that: (1) Value Line lists the core business for the four companies as being gas distribution, (2) all four of the companies derive more than 70% of their respective operating or net incomes from gas distribution, and (3) the percentage of gas distribution assets for each of the four companies is far above 70%. (Staff IB, p. 85) Moreover, the PO's reliance on utility revenues from operations fails to recognize that revenues can be greatly impacted by weather and natural gas prices. All else equal, a sample company from one year to the next could on the surface appear to be different in terms of operating risk under the ALJs' analysis due to changing gas prices even though its overall operating risk had not really changed, let alone its financial risk. (Staff IB, p. 85) That simple point demonstrates the fundamental flaw in the PO's analysis.

As Mr. McNally explained, ideally one would want a sample of companies which are 100% gas distribution companies, but that is not realistic. Therefore, one's sample has to balance measurement error due to sample composition against measurement error due to individual company cost of equity estimates. A sample must be sufficiently large to minimize the effect of any measurement error from any individual company estimate, yet still remain composed of companies whose operations are largely gas distribution. (Staff IB, p. 84) The substitution of KeySpan and Southwest Gas for AGL Resources, Peoples Energy, South Jersey Industries, and Laclede Group, as Dr. Makholm recommended, would decrease the sample size, thereby increasing the risk of measurement error from individual company estimates, with no demonstrated benefit. Indeed, Staff has demonstrated that Dr. Makholm's sample is very similar to Staff's sample in terms of total risk, based on their respective credit ratings and business profile scores,   Moreover, the PO's application to *Nicor's* sample of the same 23 basis point adjustment Staff made to reflect the risk differential between *Staff's* sample and Nicor Gas indicates that the ALJs draw that same conclusion. In fact, Dr. Makholm found that the DCF cost of equity estimate resulting from that substitution would be slightly higher than that for Staff's original sample. Thus, either the new sample is slightly riskier than Staff's original sample, and thus less similar to Nicor Gas, or the average DCF estimate reflects a higher degree of measurement error from individual company estimates due to its smaller size. Either way, Staff's original sample better balances between the two types of measurement error than the six-company sample resulting from Dr. Makholm's proposed substitution would. Thus, contrary to the ALJs' erroneous finding, Dr. Makholm's sample is, in reality, inferior to Staff's sample.

Perhaps the single most significant error in the PO's analysis is that the sole "flaw" it found to justify the dismissal of Staff's sample as unacceptable, and to consequently blindly disregard Staff's entire cost of equity analysis, also applies to the Company's sample, which the ALJs inexplicably found to be acceptable. In concluding that Staff's sample is inferior to the Company's sample, the PO puts great emphasis on the fact that, when using 2004 data, four companies in Staff's sample do not meet the 70% revenue from gas utility operations criterion. However, the record reveals that Dr. Makholm's sample does not meet that criterion either; Dr. Makholm acknowledged that KeySpan, which the Company proposes as a substitute to "correct" Staff's sample, generates only about 66% of its total revenues from natural gas distribution operations. Moreover, the record does not reveal whether KeySpan, or *any* of the companies in Dr.

Makholm's sample for that matter, *ever* met the 70% revenues from gas utility operations criterion. Further, while the PO stresses the fact that Staff's 70% revenue threshold for its sample group is slightly lower than the "more stringent standard" Dr. Makholm used (i.e., 80%), (PO, p. 85) it completely ignores the fact that Staff's criterion more stringently targeted *gas utility* operations, whereas the Company's criterion includes *all* utility operations, including electric generation, water, and sewer, whether similar to gas operations or not. (Nicor Ex. 4.0, lines 414-415; Nicor Ex. 21.0, lines 196-198) The PO concludes that the sample "must resemble Nicor Gas as closely as possible in order to accurately reflect the risks associated with the provision of gas distribution operations," (PO, p. 84) yet the record contains absolutely no evidence whatsoever to demonstrate that the risk related to the non-gas utility operations of Dr. Makholm's sample companies is representative of the risk of Nicor's gas utility operations. Thus, based on the record evidence, there is absolutely no logical reason to conclude that the Company's sample is superior to Staff's. On the contrary, as noted previously, there *is* evidence to suggest that Staff's sample is superior to the Company's.

Having inappropriately concluded that the Company's sample better reflects the risk of Nicor Gas than does Staff's sample, the PO, in turn, cites sample selection as the sole reason for rejecting a Staff cost of equity analysis consistent with those that the Commission has repeatedly, consistently accepted. The PO reasons that since its concerns regarding Staff's sample will affect Staff's DCF and CAPM estimates, the PO should reject Staff's cost of equity estimates and accept the Company's. (PO, p. 85) Even if one were to wrongly accept the PO's conclusion that Nicor's sample is superior to Staff's, Nicor witness Makholm showed that the infirmities in Nicor's DCF and CAPM analyses more than offset that which can be attributed to Staff's sample. Dr. Makholm estimated that if Staff witness McNally had used Nicor's six-company sample rather than Staff's eight-company sample, Mr. McNally's DCF estimates would have increased a mere 9 basis points, from 9.14% to 9.23%. The remaining 145 basis point difference between Nicor's DCF analysis and Staff's is due to Nicor Gas' contrived, biased growth rate estimates (133 basis points) and inadequately supported common equity flotation costs (12 basis points). (Nicor Ex. 21.0, p. 22, lines 580-581) Thus, in mistakenly seizing on sample as the sole rationale for rejecting Staff's analysis while ignoring the critical flaws in the Company's analysis, the PO has made the proverbial mountain out of a mole hill and vice versa. If the Commission is so concerned with sample composition, it should simply add 9 basis points to Staff's 9.54% cost of common equity recommendation, or 9.63%, rather than toss out Staff's entire analysis and reward Nicor an additional 133 basis points for manipulating Value Line growth data, which Staff will address next.

Despite the fact that Nicor witness Makholm's DCF and CAPM calculations contained critical errors and inconsistencies (Staff IB, pp.79-83), the ALJs, while citing the errors that Staff uncovered, failed to address the merits of those errors and inconsistencies. Rather than address the remaining errors in a thoughtful analysis, the PO simply claims that the errors did not seriously detract from Nicor's cost of equity analysis. (PO, p. 85) This is a startlingly erroneous conclusion since the 133 basis impact of Nicor's growth rate errors is almost 15 times larger than the 9 basis point impact of sample composition. Again, the Commission should not make the same mistake that the ALJs have made. The Commission must look at the evidence in the record rather than putting on blinders like the ALJs have done to avoid the issues. Dr. Makholm used two methodologies to estimate the cost of common equity, DCF and CAPM.[10] (Staff IB, p. 71 and PO, p. 75) Critical errors occur in, or are the result of, growth rates used in Dr. Makholm's DCF model and the improper application of a flotation cost adjustment.[11] (Staff IB, p. 78) The flaws in the growth rates are that for the expected growth from retained earnings, Dr. Makholm mismatched the higher return on average common equity[12] with the higher end-of-year book value which results in an overstated earnings estimate. (ICC Staff Ex. 14.0, pp. 28-29; Staff IB, p. 78) Also, Dr. Makholm erred in his calculation of the retention ratio for his sustainable growth rate by mis-matching a forecasted 2007-2009 retention ratio, with a dividend yield component that incorporates dividend expectations for 2003-2007 as well as 2007-2009 and beyond. For 2007-2009, Dr. Makholm acknowledged that Value Line forecasted a decreasing payout ratio. All else equal, a decreasing payout ratio produces a lower dividend growth in the near term than the growth Dr. Makholm assumed. As a result Dr. Makholm combined in his DCF model the higher 2003 dividend yield, reflecting the

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[10] Although, Dr. Makholm does not recommend using the CAPM, and did not include it in his original cost of common equity recommendation (Nicor Ex. 4.0, lines 737-739 and 772), the Company included it in the rebuttal phase after Dr. Makholm reduced his DCF cost of common equity estimate. (Nicor Ex. 20.0A, pp. 853-865) Thus, despite its protestations of purity of intent, the Company's requested cost of common equity is clearly outcome oriented.

[11] The PO states that it is not allowing Nicor to recover flotation costs, however as explained in a technical correction to the PO, the PO did not eliminate this error from Dr. Makholm's cost of equity estimate.

[12] The return on average common equity is higher than the return on end-of-year common equity because the denominator of the former is lower than the denominator of the latter.

higher near-term payout ratio, with a higher growth rate that reflects the lower 2007-2009 payout ratio. (ICC Staff Ex. 5.0, p. 35 and Schedule 5.13; Staff IB, pp. 78-79)

Dr. Makholm's sustainable growth rate was also biased upward due to his erroneous assumption that all new common stock will be issued at the prevailing market price. Mr. McNally pointed out that would not be the case given that stock options issued for officer and employee compensation result in stock being issued at prices below the prevailing market price. Mr. McNally even presented documents that showed without a doubt that some of the stock issuances of the companies in Dr. Makholm's sample were exercised stock options. (Staff IB, p. 79)

Dr. Makholm's "Value Line" growth rate estimates are also flawed, as he made no attempt to normalize the base year 2003 EPS data used in his growth rate estimates, despite the fact that he acknowledged the importance of normalizing data to calculate sustainable growth rate estimates. Curiously, in opting to calculate his own contrived "Value Line" growth rate estimates using Value Line EPS forecasts, Dr. Makholm ignores the EPS growth rate estimates explicitly published by Value Line, which are imbedded in the Value Line data he manipulated. Not surprisingly, the average of Value Line's published EPS growth estimates for the companies in Dr. Makholm's sample, exclusive of Nicor, Inc.,[13] is more than two full percentage points below the average of Dr. Makholm's calculated "Value Line" growth rates for the same five companies. Dr. Makholm argued that his "Value Line" growth rate estimates are preferable to the growth rates Value Line publishes, because Value Line's normalization technique is

[13] Value Line designated Nicor, Inc.'s expected growth rate as not meaningful.

flawed. However, Dr. Makholm's decision not to normalize earnings at all is not a valid solution and has led to excessive growth rates. (Staff IB, pp. 79-81)

Finally, Dr. Makholm's cost of equity analysis contained several significant inconsistencies, which the ALJs only addressed briefly by again making the blanket statement that the criticisms did not "seriously detract" from Nicor's overall analysis. (PO, p. 85). Those inconsistencies included: (1) despite using Yahoo! Finance growth rates in his CAPM analysis, Dr. Makholm excluded that very same source of growth rate estimates from his DCF analysis; (2) whenever it was convenient, Dr. Makholm praised the virtues of Value Line and criticized Staff for not using Value Line growth rates, but when Value Line's own published growth estimates became inconvenient, Dr. Makholm criticized Value Line's normalization technique and disregarded the Value Line published growth rates in favor of his own contrived estimates; (3) Dr. Makholm mismatched higher return on average equity, R_{AV}, with higher end-of-year book value, V_e, to calculate his sustainable growth rate estimates; (4) Dr. Makholm dismissed Zacks published beta estimates, although he acknowledged that Zacks is a reputable firm and used Zacks growth rates; (5) Dr. Makholm criticized the use of CAPM in utility rate cases, yet the Company included the results of Dr. Makholm's CAPM in its final cost of equity recommendation; and (6) Dr. Makholm's cost of equity recommendation for Nicor exceeds the average allowed cost of equity for a group of utilities he presented, although those companies as a group are likely significantly riskier than Nicor Gas since Nicor Gas is one of the most financially sound gas distribution utilities in the nation. (Staff IB, pp. 82-83) Each of those cases, the Company chose to disregard evidence that would have yielded a lower estimate of the cost of common equity. Once the

Commission considers the inconsistencies in Dr. Makholm's analysis and the critical errors not recognized by the PO, the Commission can only come to the reasonable conclusion that Dr. Makholm's cost of equity analysis must be rejected and that Staff witness McNally's analysis must be adopted.

Proposed amendment. Based upon the discussion above, Staff recommends that the PO be amended as follows:

> *Page 75 through Page 81*
>
> **Cost of Equity**
>
> **<u>Nicor</u>**
>
> 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 ~~ref~~disputes 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, Nicor argues that Mr. Thomas, like Mr. McNally, also erroneously fails to include flotation costs.

In sum, Nicor Gas claims that it 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. Nicor further claims that its proposal, ~~U~~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 ~~c~~Company's claim that ~~s~~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, R_{AV}, with the higher *end-of year* book value, V_e, 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. First, Staff notes that revenue is an imperfect proxy for measuring operating risk that can be greatly impacted by variable factors, including weather and natural gas prices. Thus, based on revenues alone, the same company could appear to be appreciably different in terms of operating risk from one year to the next, even though its overall operating risk had not changed. Moreover, the percentage of revenue sample selection criterion is designed to produce a proxy sample that is reasonably similar to Nicor Gas in terms of *operating* risk, but does not ensure the sample closely matches Nicor Gas's *overall* risk level, since revenues do not capture financial risk at all. Second, Staff notes that the 70% revenue requirement is not a rigid requirement. The Commission has accepted various revenue thresholds and some samples not based on revenues at all. In fact, the Commission has accepted the cost of equity from a sample with a company with percentage of revenue from gas distribution as low as 42%. Third, 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. As proof, Staff notes that (1) each of the four companies the Company proposes to eliminate still derives a substantial majority (at least 61%) of its revenue from gas distribution operations; (2) each declares gas distribution to be its core operation, is included in Value Line's natural gas distribution industry group, and has a Standard Industrial Classification code of 4924, which comprises establishments engaged in the distribution of natural gas for sale; (3) AGL Resources, Peoples Energy, and South Jersey Industries derived 74%, 82%, and 77% of their respective operating incomes from gas distribution operations, while Laclede Group derived 89% of its net income from gas distribution operations; and (4) Gas distribution assets represent 78%, 91%, 82%, and 81% of the consolidated assets of AGL Resources, Laclede Group, Peoples Energy, and South Jersey Industries, respectively. Thus, a vast majority of those companies' capital has been invested in the gas distribution business, and their investor's future earnings depend predominantly on that business.

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, effectively converting Staff's sample into the Company's sample, would create a sample that better reflects the risk of Nicor Gas. Nicor Gas presented no analysis to show that its sample is more reflective of Nicor Gas, in terms of total risk, than Staff's Gas Sample. Indeed, Staff claims that Dr. Makholm's sample is very similar to Staff's sample in terms of total risk, based on their respective credit ratings and business profile scores, and would require an adjustment similar to that which Staff made to its Gas Sample, which Dr. Makholm failed to make. Moreover, Dr. Makholm's analysis shows that his six-company sample and Staff's eight-company have almost identical costs of common equity. (Nicor Ex. 21.0, lines 219-220 and 580-581) Further, the record reveals that Dr. Makholm's sample suffers the same flaw for which he criticizes Staff's sample; Dr. Makholm acknowledged that KeySpan generates only about 66% of its total revenues from natural gas distribution operations, and thus would not meet Staff's 70% revenue from gas utility operations criterion. In fact, the record does not reveal if *any* of the companies in Dr. Makholm's sample have *ever* met that 70% revenue criterion. Moreover, the record contains absolutely no evidence whatsoever to demonstrate that the risk related to the non-gas utility operations of Dr. Makholm's sample companies is representative of the risk of Nicor's gas utility operations. Thus, Staff argues that the two for four substitution Nicor Gas proposed would reduce the sample size, thereby increasing the risk of measurement error, with no demonstrated benefit. In fact, Staff asserts that its sample is, if anything, superior to the Company's sample. 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 to Staff's original proposal 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~~ reasonableness of its methodology by pointing out that the Commission has accepted it in numerous proceedings and that it is 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, in calculating the "BR" component, Dr. Makholm mismatched the higher return on *average* equity, R_{AV}, with the higher *end-of-year* book value, V_e, which produces an overstated earnings estimate. Dr. Makholm responded by claiming that Staff simply misunderstood his calculation, and then presented a completely new basis for combining data as he did. However, Staff fully explained that no matter how one describes the Dr. Makholm's calculation, the end result is that it mismatches data from different time periods, producing an overstated growth rate estimate. Staff showed precisely where the problem lay and the Company made no attempt to challenge it.

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 Company made no attempt to dispute Staff's position.

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. Indeed, despite the Company's claim that such an assumption is eminently reasonable, Nicor provided no evidence to support that assumption. Instead, in what appears to be a grave misunderstanding of the burden of proof in a rate setting process, the Company defended its assumption by noting that Staff had not provided any information to refute that assumption. 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 then 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, Staff demonstrated that the average reported 2003 EPS for all six companies in Dr. Makholm's sample is significantly lower than that for 2001, 2002, or 2004. Thus, the growth rate implied by the geometric average change in EPS between 2003 and 2007-2009 is significantly higher than those implied by the geometric average changes in EPS from 2001, 2002, or 2004 to 2007-2009. Consequently, by selecting 2003 as the base from which growth is calculated, Dr. Makholm inflated the average growth rate for his entire sample due to his failure to normalize the base-year EPS data. (ICC Staff Exhibit 5.0, p. 37; ICC Staff Exhibit 14.0, p. 32.) Correspondingly, 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. The Company's response that five-year growth rates are the industry norm utterly fails to address Staff's criticism, which had nothing to do with the growth rate period, but rather, dealt with growth rate normalization.

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. Dr. Makholm responded by criticizing Value Line's normalization technique. That is, Dr. Makholm argued that, although based on the same underlying data, his higher "Value Line" growth rate estimates, which are not normalized, are preferable to Value Line's lower published growth rate estimates, which are improperly normalized. However, the Company's criticism of Value Line's normalization technique, even if correct, does not remedy the Company's failure to normalize. 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. Further, 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~~ criticized~~ing~~ 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 failure to adjust the equity estimate for his proxy sample, which has an average credit rating of A and business profile score of 2.5, to estimate the cost of equity for Nicor Gas. According to Staff these credit rating and business profile 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. Indeed, the higher risk of non-payment to equity holders suggests that Staff's adjustment is, if anything, understated. (Staff IB, p. 90.)

Finally, Staff also highlights that Mr. McNally's approach with regard to his 23 basis point risk adjustment 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

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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~~three 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 the reasonableness of the parties' DCF analysis growth rates. The third 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, based on the most recently available end-of-year data (2003). ~~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. While Staff's elected revenue threshold for its sample group,~~ is~~ 70%, is slightly lower, it is more specifically targeted to gas utility operations.

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 upon which the cost of equity estimate is based should~~must~~ resemble Nicor Gas as closely as possible in order to accurately reflect the risks associated with the provision of gas distribution operations. We find that matching the sample's total risk to that of the target company to be the critical objective. We also understand that building a sample that perfectly reflects the target company's total risk profile is problematic. Thus, we find that a sample that may not otherwise closely reflect the target company's total risk profile may, with the appropriate adjustment, still produce an accurate cost of equity estimate. Indeed, we find that an appropriate adjustment is *necessary* for a sample that does not closely reflect the target company's total risk profile.

The Company criticized Staff's sample, noting that ~~W~~when the revenue data for the companies chosen for the proxy samples ~~were~~was updated ~~in February~~to reflect end-of-year 200~~5~~4 data, four out of the eight companies Staff had chosen to include in ~~their~~its ~~proxy~~sample no longer ~~qualified~~

~~for~~met the~~ir~~ 70% revenue criterion Staff had adopted. The Commission finds that Staff's ~~response~~explanation ~~that the~~as to why its proxy ~~was~~remains valid despite the fact that four of the sample companies fell below the 70% threshold for 2004, is ~~insufficient~~persuasive. We find that each of those four companies remains, fundamentally, a gas distribution business, which is the purpose of using a percent of revenue criterion. We also recognize that the percent of revenue threshold is subjective and that revenues are an imperfect proxy for business risk, which, in turn, represents only a portion of the critical total risk measure. To select a sample solely on a percent of revenue criterion ignores financial risk and is, thus, insufficient; a further examination of the total risk is required. Staff performed such an examination and found its sample to be very similar to the Company's sample based on their respective Standard & Poor's credit ratings and business profile scores. Indeed, Dr. Makholm's testimony corroborates that finding. Dr. Makholm indicated that the sample substitution he proposed would increase Staff's DCF result by a mere 9 basis points and would not change Staff's overall cost of equity at all. We agree with Staff that it would be inappropriate to reduce the sample size from eight companies to six, as the Company proposes, thereby increasing the risk of measurement error, without any demonstrated benefit. We further find that, even if one accepts the Company's criticism of Staff's sample for not meeting the 70% revenue from gas utility operations in 2004, the Company's sample suffers the same flaw. In fact, the record does not reveal if *any* of the companies in Dr. Makholm's sample have *ever* met that 70% revenue criterion. Thus, we reject the Company's argument that its sample is superior to Staff's. To the contrary, we find that the Company's sample is inferior. First, the Company provided no evidence to indicate that the percent of revenue from regulated operations, including non-gas utility operations, is a reasonable measure of the business risk of gas operations. Second, as Staff notes, the higher return derived from the Company's sample indicates that that sample is either less similar than Staff's sample to Nicor Gas or its average DCF estimate contains a higher degree of individual measurement error. Either way, Staff's sample better balances the two types of measurement error. ~~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~~eight publicly-traded companies identified by ~~Nicor and accepted by CUB/CCSAO~~Staff better represents Nicor Gas and, consequently, allows 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 preference for~~concerns with~~ ~~the robustness o~~f Staff's sample notwithstanding, a thorough evaluation of the parties' analyses is still required~~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 numerous~~ certain~~ criticisms related to Nicor's ROE analysis. Nicor responds generally to Staff's criticisms of its growth rate estimate by noting that Dr. Makholm's growth rate is derived from several credible and complementary sources including *The Value Line Investment Survey*. The Commission finds that the use of multiple sources can be beneficial, but only if those multiple sources are credible and not misused. Ultimately, ~~T~~the Commission does not find ~~that~~ the Company's defense of its growth rate estimates persuasive, but rather, finds that its manipulation of Value Line data fatally compromises ~~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. Staff noted several shortcomings in the growth rate estimates Dr. Makholm employed in his DCF analysis. First, the "BR" component of Dr. Makholm's sustainable growth rate estimates mismatched the higher return on average equity, R_{AV}, with the higher end-of-year book value, V_e, which produced an overstated earnings estimate. Second, Dr. Makholm's sustainable growth rate is inconsistent with its application in his DCF model, since Dr. Makholm combined in his DCF model the higher 2003 dividend yield, which reflects the higher near-term payout ratio, with a higher growth rate that reflects the lower 2007-2009 payout ratio. Third, the SV component of Dr. Makholm's sustainable growth rate estimates is biased upward due to his failure to take into consideration the effect of issuances of stock to satisfy exercised stock options issued at below market prices. Fourth, Dr. Makholm's failure to normalize the base-year EPS data used to produce his "Value Line" growth rates resulted in inflated growth rates estimates. The Commission finds that those errors lead the Company to overstate its growth rate estimates and, thus, overstate Nicor's cost of equity.

~~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* 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.~~

Nicor criticizes witness McNally's growth rate for his DCF analysis, claiming that he uses only a single growth rate source, and erred by not including *The Value Line Investment Survey* growth rates. However, Zacks investment services averages growth rate estimates from multiple sources to derive its growth rate estimates. Moreover, although the Company extols Value Line as perhaps the most popular and credible source of all and insists that growth rates derived from Value Line data should be included in any cost of equity analysis, Dr. Makholm declined to use the growth rates published by Value Line in his analysis and criticized Value Line's normalization methods. Thus, we find the Company's criticism to be disingenuous and baseless.

Nicor also argued that Staff witness McNally erred by introducing 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 rather than calculating that dividend using the base growth rate. However, that second "subjective" growth rate was not introduced by Mr. McNally, but rather was imbedded in the actual dividends declared by the companies' boards of directors. Thus, as Staff explained, the Company position is that the Commission should reject a known dividend for an estimate of that same dividend. We find such an argument absurd.

In light of the foregoing, it is clear that we cannot accept Nicor's upwardly-biased growth rate estimates. In contrast, Staff's approach has been accepted by the Commission numerous times in previous rate setting proceedings. Further, we find that Staff's decision not to use Value Line growth rates is reasonable given the normalization problem both Staff and the Company describe. Thus, we reject the Company's approach to estimating the growth rate and find Staff's approach to be appropriate.

Next, we consider the CAPM analysis. Nicor criticized Staff's beta estimate, claiming that it is preferable to use published betas that are visible to investors. ~~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. Staff explained that the validity of a beta estimation methodology is not a function of whether the resulting beta estimates are readily visible to the market, but whether that methodology is generally accepted. The methodology Staff used to calculate the Gas Sample beta, which the Commission has accepted in numerous proceedings, is based on the widely accepted Merrill Lynch methodology. Further, Staff noted that Dr. Makholm distanced himself from his argument when confronted with the fact that Zacks, which Dr. Makholm had described as a reputable firm, publishes beta estimates for the Gas Sample based on the Merrill Lynch methodology that average 0.44, which is lower than the 0.56 beta Mr. McNally estimated through the regression methodology. Thus, we find the Company's criticism of Staff's beta to be unfounded. 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 calculation of betas growth in dividends~~. We find that the methodologies underlying both Nicor's and Staff's betas are valid and that neither parties' beta estimates is superior to the other.

Given the above conclusions, we find that the record consistently demonstrates that Staff's recommendations are based upon the valid application of sound financial theory, while those of the Company are not. Thus, the Commission adopts Staff's sample and its ROE methodology. Staff's methodology produces an ROE estimate for Staff's sample of 9.77%. However, Staff's sample is a proxy for the target company, Nicor. Therefore, a review of the relative risks of the Staff's sample and Nicor is required to evaluate how well the sample reflects the risks of Nicor. If the proxy does not accurately reflect the risk level of the target company, an adjustment to the sample ROE should be made.

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~~Staff's proxy sample has an average credit rating of A and business profile score of 2.75, which indicate that ~~Dr. Makholm's~~Staff'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~~Staff witness~~ Malkolm's~~McNally's proxy sample has an average credit rating of A and business profile score of 2.75 clearly making it more risky than Nicor Gas. The Commission finds that an adjustment is necessary to prevent ~~Dr. Makholm's~~Mr. McNally'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~~Staff's proxy group to be superior to ~~Staff's~~Nicor'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 **9.54~~10.59~~%** (the 9.77~~10.82~~% ~~originally proposed by Nicor~~preliminary estimate for Staff's sample 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.

E. Approved Rate of Return on Rate Base

Proposed amendment. The following amendments to the PO's Approved Rate of Return on Rate Base are necessary to reflect the proper inclusion of short-term debt in Nicor's capital structure and Staff's cost of common equity analysis:

Page 93

Approved Rate of Return on Rate Base

As discussed above, the Commission finds that it is appropriate to ~~exclude~~include short-term debt ~~from~~in Nicor's capital structure. The Commission also adopts a ~~10.59~~9.54% 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~~7.55%, may be summarized as follows:

Class of Capital	**Share**	**Cost**	**Weighted Cost**
Short-Term Debt	13.65%	2.58%	0.35%
Long-Term Debt	~~43.51~~36.77%	6.72%	2.~~92~~47%
Preferred Equity	0.1~~2~~1%	4.77%	0.01%
Common Equity	~~56.37~~49.47%	~~10.59~~9.54%	~~5.97~~4.72%

Total	100.00%	~~8.90~~7.55%

F. Technical Correction - Approved Rate of Return on Rate Base

The PO concludes that common equity flotation costs should not be included in the Company's cost of common equity; however, the PO cost of common equity conclusion begins with the Company's unjust and unreasonable request of 10.82% before subtracting 23 basis points for Nicor Gas' lower financial risk. (PO, p. 85) That 10.82% includes Nicor Gas' common equity flotation cost request. Hence, the PO's cost of common equity must be further adjusted downward by 8 basis points to 10.51%. This adjustment is calculated as follows: First, Makholm's upwardly biased DCF cost of common equity for the Nicor sample excluding common equity flotation costs equals 10.56%. (Column "Unadjusted ROE, k_e Before S&I (Percent)" from Nicor Ex. 21.9). Second, Makholm's upwardly biased CAPM-based cost of common equity estimate for the Makholm sample reflects a required rate of return on the market that includes 5 basis points for common equity flotation costs. (See Nicor Ex. 21.11) Without common equity flotation costs, the Makholm market risk premium equals 7.79%, not the 7.84% Dr. Makholm used. (See Nicor Ex. 21.10, p. 1 of 2, Column 4) That correction, in turn, reduces the still upwardly biased Makholm CAPM estimate of the cost of common equity from 10.95% to 10.91% as follows: 4.68% + 0.8 x (12.47% - 4.68%) = 10.91%. (See Nicor Ex. 21.10, p. 1 of 10) Averaging the flotation cost-corrected, but still upwardly biased, Company DCF and CAPM estimates results in a preliminary cost of common equity of 10.74%, not 10.82%. Subtracting 23 basis points to reflect Nicor Gas' lower total risk produces a final cost of equity for Nicor Gas of 10.51%.

Proposed amendment. If the Commission were to only correct the flotation cost error which it must do but not the PO's short-term debt and cost of common equity findings, Staff proposes the following amendment:

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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 10.51~~9~~% 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 8.85~~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%	10.51~~9~~%	5.92~~7~~%
Total	100.00%		8.85~~90~~%

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

A. Cost Of Service Study

The PO correctly based cost of service among the rate classifications upon an embedded cost of service study ("e-coss") rather than Nicor's original proposal to use a marginal cost of service study. (PO, p. 93) The PO also correctly recognizes that gas transmission and distribution mains are in service throughout the year, which plays an important role in the cost of the system being in place. Thus, it allocates transmission and distribution costs according to a combination of average and peak ("A&P") demand, rather than allocating mains costs according to only one or a few peak days under the Coincident Peak ("CP") allocation factor. (PO, pp. 100-101) Unfortunately, the PO did not choose the most appropriate cost of service study in selecting the e-coss presented by Nicor witness Heintz in surrebuttal testimony ("Nicor surrebuttal e-coss")(PO, p. 101) because that e-coss does not recognize A&P in its Modified Distribution Mains ("MDM") study.

Nicor's e-coss was apparently selected because the PO concluded that Staff witness Luth had improperly adjusted design day demand and thereby improperly adjusted the MDM study. (PO, p. 100) The PO therefore assigns the design day demand costs of the Nicor system with Nicor's artificially inflated, 18.49 percent multiplier plug factor of residential and small commercial customers demand, without any adjustment of the demand of larger customers. (PO, p. 95) The 18.49 percent increase is in addition to a projection of demand from residential and general service Rate 4 commercial customers based upon 79 Heating Degree Days ("HDDs"), which is 30 percent colder than the 61 HDDs that was the coldest day for the measurement of Maximum Daily Contract Quantities ("MDCQ") for larger customers with appropriate metering. Staff correctly concluded that demand from residential and general service commercial customers is sufficiently projected based upon 79 HDDs, without Nicor's plugged 18.49 percent multiplier added on, relative to MDCQ customers. (ICC Staff RB, pp. 75-76)

While the PO incorrectly rejects Staff witness Luth's adjustment to Nicor's estimate of relative demand, it compounds that error in relying solely upon the Nicor surrebuttal e-coss. Nicor is wrong in touting its surrebuttal e-coss as correctly using the MDM study and A&P because the MDM study does not consider A&P in its results. As Mr. Heintz explained in his direct testimony, the MDM study was originally based solely upon CP demand. (Nicor Gas Exhibit 14.0, p. 13, lines 249-257) The reason for completing a MDM study is to recognize that mains costs are a significant portion of distribution costs (Id., p. 14, lines 267-268) and attempts to eliminate assignment of costs of smaller, “downstream” mains from customers attached to larger mains. Since distribution mains are a significant portion of distribution costs, costs assigned through the MDM study should consider A&P as well as CP. If the MDM Study in Nicor’s surrebuttal e-coss had assigned mains costs according to A&P, the results of the surrebuttal MDM Study would have been different from results of the direct MDM Study.

A comparison of the Distribution Mains revenue requirement assigned through the MDM study in the Nicor e-coss from direct testimony (Nicor Gas Exhibit 14.1, Schedule F) with Mains revenue requirement assigned in surrebuttal testimony (Nicor Gas Exhibit 42.1, Schedule F) shows that Mr. Heintz did not adjust the MDM study to include A&P in the assignment of Mains revenue requirement, as shown below:

	Nicor Gas Exhibit 14.1, Schedule F (000s)	Percentage	Nicor Gas Exhibit 42.1, Schedule F (000s)	Percentage
Rate 1	$ 115,152	.69859	$ 46,070	.69859
Rate 4	27,995	.16984	11,200	.16983
Rate 6	51	.00031	20	.00030
Rate 7	0	.00000	0	.00000
Rate 10	2	.00001	1	.00002
Rate 11	2	.00001	1	.00002
Rate 17	748	.00454	299	.00453
Rate 74	17,233	.10455	6,895	.10455
Rate 76	2,278	.01382	911	.01381
Rate 77	1,121	.00680	449	.00681
Rate 81	252	.00153	101	.00153
Total	$ 164,834		$ 65,947	

As shown in the table above, the percentages of Distribution Mains revenue requirement assigned to the various customer classes did not change between Nicor direct and surrebuttal testimony. Had Nicor's surrebuttal e-coss taken A&P into consideration in assigning distribution mains costs, the percentages of distribution mains revenue requirement among the customer classes would have been different from the percentages in its direct testimony. Since the Nicor surrebuttal MDM study does not consider A&P, it should be adjusted if it is to be the basis from which rates are to be designed.

The previous table also shows that Total Distribution Mains revenue requirement was reduced by 60 percent in Nicor's surrebuttal e-coss compared to its direct testimony e-coss ($164,834 down to $65,947). Nicor did not explain why this significant, $99 million shift in cost classification occurred, which makes the consistency of Nicor's surrebuttal e-coss questionable.

Nicor's MDM Study and e-coss overstate Rate 1 and Rate 4 demands relative to other rates because of the unnecessary, arbitrary 18.49 percent multiplier applied to the projected Rate 1 and Rate 4 demands based upon a 79 HDD. The MDM Study and e-coss should therefore be adjusted to eliminate the 18.49 percent multiplier applied to demands of Rate 1 and Rate 4, as Staff's e-coss did. Additionally, the MDM Study should not be solely CP-based, and should therefore be adjusted to consider A&P. The Order should adopt Staff's e-coss as a basis for rates in this docket because it has the best relative measurement of demands among the rate classes and includes A&P in assigning distribution mains costs. If the Commission is concerned that Staff's e-coss does not properly differentiate the rate classes in assigning the minority percentage (24 to 26 percent) of distribution mains revenue requirement based upon volume, Staff's assignment of distribution mains costs based upon volume can be adjusted so that customer classes with little or no usage of smaller, "downstream" distribution mains are not assigned a full percentage of volume-based distribution mains revenue requirement from smaller, "downstream" mains.

Proposed Amendment. Based on the above discussion, Staff recommends that the language in the PO be amended as follows:

Pages 100 through 101

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~~,~~ and IIEC~~,~~. ~~and~~ Staff supports the use of the MDM study to the extent distribution mains costs should be allocated according to peak demand. The Commission rejects 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~~ because the Company's projection of Rate 1 and Rate 4 demand is overstated by use of an 18.49 percent multiplier plug factor. 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~~ MDM Study should be adjusted so that it is based upon A&P, rather than CP alone.

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~~ agrees with much of the ECOSS methodology offered by Nicor in the surrebuttal testimony of Mr. Heintz. (*See* Nicor Ex. 42.1.) That study ~~best uses~~ applies both the MDM study and the A&P method, ~~and is the appropriate ECOSS for setting rates in this case~~ but it should be adjusted to eliminate the 18.49 percent multiplier to projected demands from Rates 1 and 4, and include A&P in the MDM Study. 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~~ ~~total~~, has the best measure of relative customer class demands and ~~thereby improperly adjusts the MDM~~ should be used as the basis for setting rates. 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.

B. Rates, Riders, and Other Terms

1. Rate 1

The PO accepts Nicor's recommended declining 3-block volumetric billing structure for Rates 1, 4, and 74 (PO, pp. 103 and 155). In accepting Nicor's declining volumetric billing structure, the PO mismatches demand and volumetric cost causation with how customers are billed. It is generally agreed that increased demand and volume causes increased distribution costs, with the result that increased demand and volume results in an increased allocation of costs. With Nicor's recommended declining volumetric billing structure, the highest levels of demand and volume are billed at the lowest rates because the highest levels of demand and volume are billed through the highest volume block, which is the lowest-priced per unit of volume last block. In an era of increasing natural gas prices, a declining volumetric billing structure provides a pricing signal that increases in natural gas usage are less costly than lower levels of usage. The Commission should not inversely price gas distribution charges with cost causation through Nicor's proposed three-block distribution charge structure, as recommended in the PO (Id.). The Commission should accept Staff's recommended nearly flat, 2-block volumetric billing structure for Rates 1, 4, and 74. By adopting Staff's recommended nearly flat, 2-block volumetric billing structure, the Commission would be consistent with its recent natural gas rate design conclusions in Docket Nos. 02-0798, 03-0008, & 03-0009 (Cons.) (Docket Nos. 02-0798, 03-0008, & 03-0009 (Cons.), Order, pages 116 and 117), and Docket No. 04-0476 (Docket No. 04-0476, Order, page 79).

Proposed Amendment. Based on the above discussion, Staff recommends that the language in the PO be amended as follows:

Page 103

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 a~~An essentially flat distribution rate ~~would~~ might increase the weather sensitivity of Rate 1 customers to some extent~~.~~, but, as 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.~~ Furthermore, any increased weather sensitivity resulting from a nearly flat volumetric distribution rate structure is outweighed by the consistency of rates with cost causation and allocation under Staff's distribution rates. Nicor's proposed continued declining three-block distribution rates is inconsistent with cost causation and allocation because Nicor's proposal sends an inappropriate price signal, particularly in an era of escalating natural gas prices, that increased volumes of gas distributed are less costly than smaller volumes of gas distributed.

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~~ Staff's proposed customer charge ~~of $8.40~~ that fully recovers customer costs and ~~three~~ nearly flat, two block distribution rate 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.~~ The Commission concluded that flat distribution charges were appropriate in Docket Nos. 02-0798, 03-0008, and 03-0009 (Cons.), and Docket No. 04-0476, and concludes that a similar rate structure in this docket is appropriate.

2. Rider 6

a. Allocation of Hub Revenues through the Revenue Requirement

The PO's analysis and conclusion regarding the issue of allocation of HUB revenues appears to be incomplete. The PO, on page 177, correctly finds that the benefits of HUB revenues "should be provided to all customers, including Sales, Transportation, and Select customers." However, the PO fails to provide adequate instruction on how NICOR should implement its finding. Regarding implementation, the PO acknowledges Staff's concern that use of a base rate credit for HUB revenues "gives Nicor an incentive to provide Hub services in a manner that may result in higher gas costs for Sales customers." PO, p. 177. The PO also notes (i) Staff's position that both Sales customers (who take service under Rider 6 – Nicor's PGA clause) and Transportation customers (who do not take service under Rider 6) could receive credits for HUB revenues via Rider 6 or an amendment to Rider 6, and (ii) Nicor's acknowledgement that it could issue a credit to Transportation customers via the PGA mechanism (i.e., Rider 6).[14] Although the PO acknowledges the reasonableness of Staff's position by stating that "[d]elivery of the credits to Transportaion customers via a separate rider would be equitable, or even via Rider 6 if modifications could make that

[14] In his surrebuttal testimony, Nicor witness Mr. Harms testified that "if the Commission desires to provide a benefit to all customers, that can still be handled appropriately through the Gas Supply Cost mechanism by allocating a credit to all customers based on throughput." (Nicor Gas Exhibit 44 (Corrected), p. 14, lines 306-308)

possible", the PO concludes without resolving this issue by stating that "[u]ltimately, however, the Commission finds that there is no such rider in the record of this case." Id.

As noted above, this section of the PO is incomplete, so it is difficult to discern the meaning of the sentence in the PO stating that "there is no such rider in the record of this case." In any event, although it is correct that language modifying Rider 6 to credit Transportation customers for HUB revenues is not in the record in this case, this is no reason to reject or avoid the most if not only reasonable means of implementing the Commission's finding that all customers should share the benefits of HUB revenues. This is not a true deficiency in the record, but rather only reflects the fact that Nicor's filed tariff's proposed a different credit mechanism. It is clearly within the Commission's power and ability to order Nicor to file a compliance tariff that accomplishes a specific directive or result and, more importantly, Nicor has already acknowledged that such a result can be accomplished. (Nicor Gas Exhibit 44 (Corrected), p. 14, lines 306-308) Staff also notes that under Illinois law the Commission has broad authority to address any rate or rider in a general rate case, even if not specifically proposed for modification by the utility in its initial filing. *City of Champaign v. Illinois Commerce Commission*, 141 Ill. App. 3d 457, 461 (4th Dist. 1986) ("Our conclusion that the ICC is authorized to alter rates in addition to those specifically proposed for alteration is consistent with modern practice in the regulation of public utility rates.")

In Staff's opinion, the apparent word processing errors in this portion of the PO may be easily addressed by adding language to the PO: 1) indicating that HUB revenues are to be credited through the PGA to sales customers, and 2) instructing

NICOR to make the necessary compliance filing to allow for Transportation customers to receive credits based on throughput via the PGA.

Proposed Language Changes

Based upon the discussion above, Staff recommends that the Proposed Order be amended as follows:

Page 177, first full paragraph:

While RGS would like to see all customers credited via a reduction in base rates~~ 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 and Transportation customers via Rider 6 (Nicor's PGA clause)~~ 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 it ~~the Commission~~ could provide a credit to all customers through the Gas Supply cost mechanism via the PGA if desired by the Commission. The Commission agrees with Staff that ~~D~~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~~ would be equitable and avoid imposing incentives to provide Hub services in a manner that may result in higher gas costs for Sales customers. 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~~ and Nicor has testified that it can implement such a credit mechanism. The Commission therefore orders NICOR to ~~Staff argues that Nicor would have to~~ develop and file as a compliance filing the appropriate rider language to credit Hub revenues through the Gas Supply Cost mechanism by allocating a credit to all customers based on throughput. ~~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~~.

VI. OTHER TECHNICAL CORRECTIONS

Rate Base (short list of uncontested issues)

On page 4 of the PO, paragraphs are included under the headings "Accumulated Deferred Income Taxes" and "Deferred Taxes". Staff has two technical corrections to this part of the PO. First, Staff's adjustment discussed under Accumulated Deferred Income Taxes to which Nicor agreed was for the Section 263A issue which was contested by the AG and is more fully discussed later in the PO. Therefore, Staff proposes that the first full paragraph on page 4 of the PO under Rate Base be deleted in its entirety.

~~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.~~

Second, since the paragraph headed "Deferred Taxes" is more appropriately described as Accumulated Deferred Income Taxes, Staff proposes the following heading change on page 4 of the PO:

<u>Accumulated </u>Deferred <u>Income </u>Taxes

Utility Plant Balance/Accumulated Depreciation/Deferred Taxes

The PO's adjustment to utility plant balance and the related adjustments to accumulated depreciation and deferred taxes were based upon Staff's recommended adjustments which used the average test year rate base. However, the PO did not accept Staff's recommended average test year rate base adjustment. Previously, Staff discussed why the Commission should accept Staff's proposed adjustment to convert the Company's year-end rate base to an average rate base for the test year. Should the Commission reject Staff's arguments, which it should not, the PO's adjustment to utility plant balance and the related adjustments to accumulated depreciation and deferred taxes should be corrected. In addition, the PO's calculation of accumulated depreciation did not include the adjustment for accumulated depreciation for the daily metering project adjustment and the mainframe computer adjustment. Attachment A to this brief on exceptions computes the correct adjustments for utility plant balance and accumulated depreciation under the various scenarios proposed in the case. Attachment A also computes the correct adjustment for deferred taxes.

Section 263A

The second full paragraph under the subsection "Staff" on page 25 of the PO fails to accurately summarize Staff's position regarding the Section 263A issue. The AG not Staff found the Section 263A election as being entirely speculative. As a result, the second full paragraph under "Staff" concerning the Section 263A election requires the following technical corrections:

> Staff disagrees with AG witness Effron's proposed adjustment to ADIT. ~~Staff~~ The AG 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.

Rider 12

The second full paragraph under the subsection "Staff" on page 184 of the PO, which summarizes Staff's position with respect to the Rider 12 issue, fails to identify the specific USOA account and therefore requires the following technical correction:

> 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 <u>188 Research, Development, and Demonstration Expenditures</u>.

Staff further proposes an additional technical correction to the Commission Analysis and Conclusion for the Rider 12 issue included in the PO on pages 184-185 of the PO given that the Illinois Power tariff was not accurately quoted. Staff proposes the following technical correction:

> 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~~ <u>associated with</u> MGP plant: … .

Rate Base vs. Base Rates

There are instances where the PO uses the term "rate base" but where, based upon the context, the term should be "base rates." Therefore, Staff proposes the following technical corrections:

> 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 base rates ~~rate base~~. (PO, p. 169)

***

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 base rates ~~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 base rates ~~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. (PO, p. 174)

***

While RGS would like to see all customers credited via a reduction in base rates ~~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. (PO, p. 177)

***

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 <u>base rates</u> ~~rate base~~. (PO, p. 177)

***

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 <u>base rates</u> ~~rate base~~, given their amounts and volatility. (PO, p. 178)

***

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 <u>base rates</u> ~~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%. (PO, p. 178)

***

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 <u>base rates</u> ~~rate base~~. (PO, p. 179)

***

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 <u>base rates</u> ~~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 <u>base rates</u> ~~rate base~~. The gas cost portion of Nicor's uncollectibles is presently being

> recovered through base rates ~~rate base~~ and should continue to be recovered through base rates ~~rate base~~. (PO, p. 180)

VII. CONCLUSION

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

Respectfully submitted,

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