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	:	
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REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Table of Contents

Page

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

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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 Reply Brief on Exceptions to the briefs on exceptions filed by Northern Illinois Gas Company (“Nicor BOE”), the People of the State of Illinois (“AG BOE”), Illinois Industrial Energy Consumers (“IIEC BOE”) and the Citizens Utilities Board and Cook County States Attorney’s Office (“CUB/CCSAO BOE”) in response to the Administrative Law Judges’ Proposed Order (“Proposed Order” or “PO”) issued August 17, 2005.

I. INTRODUCTION

II. RATE BASE

A. Year-End or Average Rate Base Methodology

Northern Illinois Gas Company (“Nicor Gas”, “Nicor” or the “Company”) proposes to add a sentence to the “Nicor” summary section on page 5 of the PO. (Nicor BOE, p. 11) The new sentence reflects an argument that Nicor Gas made during this proceeding. While Staff questions the argument's accuracy (ICC Staff Exhibit 10.0-Revised, pp. 12-14) and disagrees with the Company about the weight the Commission should give this argument (ICC Staff Exhibit 10.0-Revised, pp. 14-15); it is, nevertheless, an argument the Company made. Therefore, Staff does not oppose the inclusion of the sentence in the section that summarizes the arguments Nicor Gas presented.

B. Utility Plant Balance

In Nicor's Brief on Exceptions, it again argues that Staff's adjustment to Utility Plant Balance should be rejected because of the "broad, deep, and compelling evidentiary showing in support of its 2005 forecasts and budgets." (Nicor BOE, p. 11) This argument is misleading and irrelevant. Staff witness Griffin did not propose his adjustment because of any flaw in Nicor's budget procedure but rather to reflect, for ratemaking purposes, the variances between actual and budgeted capital expenditures which were shown to have been historically volatile. (Staff IB, p. 13, ICC Staff Exhibit 13.0, p. 2, ll. 32-35)

Nicor also argues that the variances for 1998 and 2002, which were -17.5% and -6.4% respectfully, should not have been included in Staff's adjustment because they were atypical. (PO, p. 12) The Company apparently had no problem including 2003's atypical +8% variance. However, the point of the adjustment is to consider all variances between budget and actual capital expenditures regardless of the reason for the variance. For that reason, it would also be improper to adjust the 2002 variance to account for any atypical event as suggested by Nicor. (Nicor BOE, p.13)

Finally, Nicor notes that its 2005 capital expenditures are currently expected to exceed budget by $1,500,000. (Nicor BOE, p. 13) Although there is no evidence in the record of this, it only strengthens Staff's position that (despite the broad, deep and compelling evidence supporting their forecasting procedures) Nicor's capital expenditures budget cannot be relied upon for ratemaking purposes. As a result, Nicor's arguments must be rejected.

The PO correctly concludes that a plant adjustment is warranted because of the pattern of variances between the forecast and actual net plant additions. However, as explained in Staff's Brief on Exceptions, the Commission should base that adjustment upon the variances from 1998 to 2004. (Staff BOE, pp. 14-16)

C. Mainframe Project

The PO correctly accepted Staff witness Griffin's adjustment to the Mainframe Project reducing the cost by $522,000 to reflect the early purchase discount that Nicor received. The only argument Nicor puts forth is that the evidence in the record supports its budgeting and forecasting. (Nicor BOE, p. 13) Staff notes that Nicor admits that its actual capital expenditures for 2005 are expected to exceed budget by $1,500,000. (Id.) In fact, the quality of the Company's budgeting procedures is irrelevant to this adjustment. As the PO correctly states, "The Commission finds the actual amount expended on the Mainframe Project to be significant. It is undisputed that there was an early purchase discount received by Nicor for the mainframe project. Therefore, the Commission finds that a deduction is appropriate to properly reflect this discount in rate base."

Nicor's substitute language should be rejected and PO's language and adjustment reducing plant in service by $552,000 should be retained.

D. Daily Metering Project

The PO correctly accepted Staff witness Griffin's adjustment to the Daily Metering Project. On page 14 of its Brief on Exceptions, Nicor argues that Mr. Griffin's reading of the language in the Company's internal policy is arbitrary. The language in the internal policy, is reproduced in Mr. Griffin's testimony (ICC Staff Exhibit 4.0, p. 5, ll. 93-100) and in the PO (p. 13) The Commission can determine for itself whether Mr. Griffin's interpretation is arbitrary, which it is not. The language in the policy is very clear and speaks for itself. The policy clearly refers to total cost and does not exclude overheads. If an internal policy is not followed, then it is by definition violated.

Nicor also argues that "Nicor Gas submitted uncontradicted evidence that the project was prudent and used and useful and its costs were reasonable." (Nicor BOE, p. 14) However, the Company did not demonstrate that the cost of the project was prudent. The written policy which the Company has violated is an internal control measure that helps to assure that the money spent on a capital project is prudent. (Staff RB, pp. 16-17) The Company violated this policy. Therefore, the evidence is not uncontradicted and the Company's argument must be rejected.

As the PO states, "Nicor's consistent violation of its own policy does not absolve them of the violation." The Commission should reject the substitute language proposed by Nicor and retain the PO's language and adjustment reducing plant in service by $389,000.

E. Pension Asset

<u>The Net Pension Asset</u>

The PO concluded correctly that the net pension asset should be excluded from Nicor Gas' rate base. Since the pension asset was created by ratepayer-supplied funds rather than shareholder-supplied funds, the shareholders should not be able to earn a return on the prepaid pension asset. (ICC Staff Exhibit 3.0, pp. 2-4, ll. 36-73 and ICC Staff Exhibit 12.0, p. 4, ll. 63-75)

Nicor Gas disagrees with the PO's conclusion. (Nicor BOE, pp. 18-25) Nicor Gas asserts that the PO is incorrect in its ruling that the pension asset was created by ratepayer-supplied funds, not by shareholder-supplied funds. In fact, the Company argues:

> As we previously said, Staff and the AG somehow reach the conclusion that customers paid for the net pension asset. That is tortured and false. (Nicor BOE, p.21)

However, the evidence demonstrates that the PO is correct.

Staff's "tortured" and "false" position, which the PO correctly accepts, begins with the Commission's finding in Nicor Gas' last rate order where the Commission stated:

> [T]he Commission finds that the proposal to eliminate the net Pension Asset from rate base is consistent with past Commission orders **which found that the overfunded pension asset was created from ratepayer-supplied funds**. The Commission adopts Staff's recommendation to eliminate a net $39,798,000 from the test-year rate base, which reflects the difference between the Pension Asset adjustment and the related ADIT adjustment. **The Commission also rejects NI-Gas' arguments in briefs that the adjustment constitutes retroactive and single-issue ratemaking.** Staff's approach is not retroactive ratemaking because it is not an attempt to correct for a past error or omission, rather the adjustment disallows, on a prospective basis, an asset that NI-Gas proposed to include in test-year rate base for the first time. Similarly,

> Staff's approach is not single-issue ratemaking because Staff evaluated all rate base components, including the pension asset, in the aggregate on the same basis. In addition, NI-Gas also proposes to remove either the OPEB deduction from rate base or the pension credit from operating expense. These proposals are rejected. NI-Gas continues to control the ratepayer-supplied OPEB funds, and the pension credit is an item that NI-Gas will realize in the test year. (Order dated April 3, 1996, Docket No. 95-0219, pp. 9-10) (**emphasis added**)

Further, despite to the Company's allegations to the contrary, the evidence demonstrates that the pension asset was created by ratepayer-supplied funds. The pension asset results from changes in actuarial pension assumptions used by Nicor and returns on trust assets in excess of those assumed on the funds provided by ratepayers for the trust assets. The trust funds now generate returns and net gains, both of which more than offset the cost of annual pension benefits earned by employees in a given year. Since the pension asset was created by ratepayer-supplied funds rather than shareholder-supplied funds, the shareholders should not be able to earn a return on the prepaid pension asset. (ICC Staff Exhibit 3.0, pp. 2-3, ll. 38-55 and ICC Staff Exhibit 12.0, p. 4, ll. 66-70)

The record is also clear that the situation has not changed since the Company's last rate order. The Company acknowledged that due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. (Nicor Gas Exhibit 26A.0, p. 56, ll. 1266-1267)

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

Nicor Gas' argument that ratepayers did not fund the pension trust because the ratepayers "did not write the check" is ludicrous on its face. (Nicor BOE, p. 20) Nicor Gas' argument simply confuses the final payment of funds with the source of the funds that were paid. Taken to its logical conclusion, the Company's argument leads to nonsensical results. It would mean that the Company does not recover any of its costs from ratepayers because it is the Company, not the ratepayers, that must ultimately "write the checks" to pay the Company's vendors. The ratepayers are the source from which the Company recovers its costs and pays its bills. Those costs include the Company's previous estimate of its pension costs.

Nicor Gas argues that the Staff's and Attorney General's ("AG") theory, which the PO accepts, constitutes a novel combination of retroactive and single-issue ratemaking. (Nicor BOE, pp. 22-23) The PO concludes correctly that this is not the case. (PO, p. 22) The PO notes that the Commission in the Company's last rate case explained why this adjustment constitutes neither retroactive nor single-issue ratemaking (see above). The adjustment does not attempt to correct for past errors or omissions. Rather, the adjustment recognizes the extent to which the Company's pension plan is over funded on a going forward basis. This is why it is appropriate not only to eliminate the pension from the Company's rate base but to reflect the resulting negative pension expense the Company will have on a going forward basis (Nicor BOE, pp. 24-25).

In one of its alternative positions, the Company states

> Alternatively, Nicor should be allowed to include $67,900,000 of the net pension asset in rate base. … the net pension asset increased … since

> the 1995 Rate Case, but during this period customers have not paid one cent of pension expense … . (Nicor BOE, p. 23)

The implication being that Nicor has somehow contributed to this increase. However, as noted above, the Company has already acknowledged that due to the funded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. (Nicor Gas Exhibit 26A.0, p. 56, ll. 1266-1267) Therefore, this and all proposed alternatives must be rejected.

The Commission should reject the changes proposed by Nicor Gas as well as the other various alternatives the Company offers. The PO found correctly, based upon the evidence in this proceeding, that the pension asset should be eliminated from rate base and the resulting negative pension expense should be reflected in the Company's operating expenses. The PO further notes correctly that the Company has provided nothing in this case to show why the Commission should arrive at a different conclusion in this proceeding than it reached in the Company's last rate case with the same pattern of facts.

<u>The Pension Credit</u>

Nicor Gas also takes exception to the PO for leaving the pension credit in the Company's test year. (Nicor BOE, pp. 24-25) Nicor disagrees with the PO's statement that, "The pension credit is an item that Nicor will realize in the test year." (Nicor BOE, p. 24) However, the PO's conclusion is supported by the evidence in this proceeding. The Company acknowledged that, due to the overfunded status of the pension plan, it was not required to contribute to the pension trust from 1997 through 2003. (Nicor Gas Exhibit 26A.0, p. 56, ll. 1266-1267) As Staff witness Pugh noted, "No cash outlay of funds is required as a result of the negative pension expense." (ICC Staff Exhibit 3.0, p. 3, l. 56) Clearly, the Company realizes the pension credit in the test year.

Since the pension asset results from overfunding by ratepayers and healthy pension fund earnings, the Company has been allowed to record a negative pension expense since the previous rate case. This negative pension expense (credit) should be passed through to benefit ratepayers because it is the calculated projected net periodic benefit cost (credit) for the 2005 test year. Rates are based upon the Company's projected needs during the time in which the rates set in this proceeding will be in effect.

The Commission should reject the substitute language proposed by Nicor Gas. The PO concluded correctly that the negative pension expense (credit) should be reflected in the test year.

F. Budget Payment Plan

Nicor continues to use its stale argument regarding selective adjustments to specific items for its disagreement with the PO's conclusion on the AG's Budget Payment Plan adjustment. (Nicor BOE Exhibit 1, p. 31) The Company proposes various alternatives using its forecasted numbers and the 3-year methodology all with varying results. (Nicor BOE, pp. 27-28) None of these alternatives however corrects for the $40 million forecasting error for May 2004. The PO correctly finds that the AG's proposed adjustment which corrects a $40 million forecasting error is appropriate. (PO, p. 28)

G. Customer Deposits

Similar to the issue of Budget Payment Plan balances, the Company continues to argue against what it describes as selective proposals. (Nicor BOE Exhibit 1, p. 33) The Company's only rebuttal to -AG witness Effron's adjustment to Customer Deposits is that it does not agree to make what it calls "selective updates" to rate base components. (Nicor Gas Exhibit 26A.0, p. 69, ll. 1568 – 1569) Mr. Effron disagrees with the Company's characterization of the adjustment as a "selective update" but rather avers that the Company's method of forecasting is faulty and his correction of that faulty method does not constitute a selective update. (AG Exhibit 1.3, p. 14, ll. 17 – 19) The PO correctly finds that the AG's adjustment more appropriately reflects a reasonable balance for Customer Deposits based on actual numbers rather than company projections which are not supported by actual numbers. (PO, p. 29)

III. EXPENSES

A. PGA and ECR Revenues

Nicor Gas proposes to add clarifying language to the PO's discussion of the PGA and ECR adjustment. (Nicor BOE, p. 33) Staff does not oppose the addition of this clarifying language.

B. Industry Association Dues

The PO concluded correctly that costs related to certain community organizations should not be recovered from Nicor Gas' ratepayers. (PO. p. 33) The nature and purpose of the organizations demonstrate that membership in the community organizations are of a promotional, goodwill or institutional nature. (ICC Staff Exhibit 3.0, pp. 15-16, ll. 345-350 and ICC Staff Exhibit 12.0, p. 17, ll. 365-371)

Nicor Gas disagrees with the PO's conclusion, citing references to its initial brief and reply brief, and presents substitute language for the Order accordingly. (Nicor BOE, p. 34) The Commission should reject the Company's proposed language and retain the language conclusion set forth in the PO.

The organizations in question are listed on ICC Staff Exhibit 12.0, Schedule 12.04, page 2 of 2. Participation in such groups is a promotional and goodwill practice, which, while perhaps promoting good corporate citizenship and enabling employees to keep in contact with other members of the business community, is not necessary in providing utility service. Payments to various chambers of commerce and business and economic development organizations are more appropriately characterized as dues or promotional activities for which the Company receives membership or promotional benefits in return for payment of those dues. Consequently, the ratepayers should not be burdened with the expense of the Company taking part in these community organizations. (ICC Staff Exhibit 3.0, p. 16, ll. 351-356) The PO does allow recovery of dues for membership in energy-related organizations because they are a resource for energy-related information. However, the chambers of commerce and economic development organizations are not necessary to providing utility service and should not be included in the revenue requirement. The PO is correct that the Company has failed to show otherwise.

C. Social and Service Club Dues

The PO concluded correctly that costs related to certain community organizations should not be recovered from Nicor Gas' ratepayers. (PO. p. 33) Participation in such groups is a promotional and goodwill practice. (ICC Staff Exhibit 3.0, p. 17, ll. 378-384 and ICC Staff Exhibit 12.0, p. 20, ll. 417-423)

Nicor Gas disagrees with the PO's conclusion, citing references to its initial brief and reply brief, and presents substitute language for the Order accordingly. (Nicor BOE, p. 34) The Commission should reject the Company's proposed language and retain the language conclusion set forth in the PO.

The organizations in question are listed on Nicor Gas' Schedule C-6, pages 9-11. The information listed on this schedule as the purpose and nature of each organization clearly shows that these organizations are to promote the interest of business in the community. Membership in the chambers of commerce and economic development organizations is not necessary to providing utility service and should not be included in the revenue requirement. Participation in such groups is a promotional and goodwill practice, which, while perhaps promoting good corporate citizenship and enabling employees to keep in contact with other members of the business community, is not necessary in providing utility service. Payments to various chambers of commerce and business and economic development organizations are more appropriately characterized as dues or promotional activities for which the Company receives membership or promotional benefits in return for payment of those dues. Consequently, the ratepayers should not be burdened with the expense of the Company taking part in these community organizations. (ICC Staff Exhibit 3.0, p. 17, ll. 381-387) The PO is correct that the Company has failed to show otherwise.

D. Office Supplies Expense

The PO concluded correctly that test year office and supplies expense should be reduced from $23,633,000 to $18,566,000. (PO, p. 35) The amount proposed by Nicor Gas for the 2005 forecasted, future test year represents a 40% increase over the actual amount for 2004. (AG Exhibit 1.3, p. 19) The evidence does not support an increase of this magnitude. The Commission should reject the substitute language proposed by Nicor Gas and retain the PO's language and adjustment reducing test year office supplies and expenses to $18,536,000.

E. Branding Expense

The PO concluded correctly that test year advertising expenses should be reduced by $339,625 attributable to branding expenditures. (PO, p. 37) These expenditures are not necessary for the provision of utility service and should not be included in the Company's revenue requirement. (AG Exhibit 1.0, p. 26, ll. 2-11) The Company has not shown that marketing intelligence and branding benefit ratepayers. The Commission should reject the substitute language proposed by Nicor Gas and retain the PO's language and adjustment reducing test year advertising expenses by $339,625.

F. Storage Gas Losses (2% Withdrawal Factor)

The PO concluded correctly that Nicor Gas should recover its storage Gas losses through base rates rather than through Rider 6, the Company's PGA Clause. (PO. pp.

39-40) The Company's proposal violates 83 Ill. Adm. Code 505, the Uniform System of Accounts for Gas Utilities, and 83 Ill. Adm. Code 525, the Commission's PGA Rule. (ICC Staff Exhibit 12.0, pp. 12-13, ll. 242-274) The Commission should not allow this to continue. The Commission should reject the substitute language proposed by Nicor Gas and retain the PO's language and $9,971,865 adjustment.

G. Corporate Benefit Plan Expense

The PO concluded correctly that test year operation and maintenance expenses should be reduced by $1,103,000 for corporate benefit plan expenses. (PO, p. 41) Nicor Gas' forecast assumes 100% payout ratio. The evidence demonstrates that in the five years preceding the test year, the payout ratio never reached 100%. Furthermore, the actual payout ratio for 2003, on which the adjustment is based, approximates the payout ratio for the five years preceding the test years. (Tr. 414-415, ll. 14-13) The Commission should reject the substitute language proposed by Nicor Gas and retain the PO's language and adjustment reducing test year operating and maintenance expenses by $1,103,000.

H. Incentive Compensation

The Company claims that there is no basis for disallowing incentive compensation expenses. (Nicor BOE, p. 42) Staff's basis for disallowing the expenses is clearly set forth in the evidence in this case. Staff witness Pugh's proposed adjustment to disallow incentive compensation and associated payroll taxes related to the 2005 Bonus Plans are for the following reasons:

1. The incentive compensation programs (“programs”) are dependent upon financial goals of the Company which benefit shareholders and not ratepayers;

2. The goals in the programs may not be met and thus no cost would be incurred by the Company yet ratepayers would have provided funding; and,

3. The disallowance of incentive compensation is consistent with prior Commission Orders. (ICC Staff Exhibit 3.0, pp. 4-5, ll. 81-88 and ICC Staff Exhibit 12.0, p. 7, ll. 134-141)

Staff further described each of these three main points in its Direct Testimony, Rebuttal Testimony, Initial Brief and Reply Brief (ICC Staff Exhibit 3.0, pp. 4-8, ll. 74-161, ICC Staff Exhibit 12.0, pp. 7-10, ll. 128-213, Staff IB, pp. 44-47 and Staff RB, pp. 32-33).

The PO accurately sets forth the criteria for allowing incentive compensation expense for recovery in a rate case (PO, p. 44). The Company’s discussion of its total compensation (Nicor BOE, pp. 43-48) does nothing to demonstrate the tangible benefits to ratepayers required for recovery. Furthermore, the Company has failed to support its position by providing the detailed evidence of objectives measured by tangible or quantifiable results and the specific dollar savings or tangible benefits conferred upon ratepayers from its incentive compensation plan. The Company did not cite any specific instances of hiring problems within its labor market. Furthermore, the Company did not provide clear evidence showing that incentive compensation payments are necessary to pay the labor market average and to retain employees. (ICC Staff Exhibit 12.0, p. 9, ll. 174-180)

Nicor’s argument that it is “tautological” that every dollar of incentive compensation expense reduces one dollar of base pay (Nicor BOE, p. 46) is ridiculous at best, especially when one considers that incentive compensation is based on attainment of certain goals. Would it then be correct that if an employee did not attain those goals, their base pay would increase as incentive compensation decreased? Where is the incentive if an employee's base pay decreases as incentive compensation increases? The evidence in this case does not prove this claim made by the Company.

Nicor dedicates several pages of its Brief on Exceptions (pp. 42-46) on the argument that it has presented uncontradicted evidence that

> … it is common for employers in the utility industry to pay incentive compensation, and that Nicor Gas' incentive compensation programs are low in amounts when compared to the incentive compensation programs are low in amounts when compared to the incentive compensation packages of other utilities, both in terms of potential dollar value payout and in terms of percentage of incentive compensation as compared to the total compensation package. (Nicor BOE, p. 42)

Nicor's argument just like the evidence presented on this issue misses the mark. As stated earlier, the criteria that must be met is as set forth in the PO on page 44, namely, the Company must demonstrate that its plan has reduced expenses and created greater efficiencies in operations. The evidence presented by Nicor does not address this criteria and thus is irrelevant. Simply put, Nicor has failed to meet its burden with respect to this issue.

The PO's language setting forth the Commission Analysis and Conclusion thoroughly describes the appropriate criteria for consideration of recovery of incentive compensation and correctly concludes that the Company failed to provide the necessary support for the requested recovery of the incentive compensation expense.

Therefore, the language in the PO on the issue of incentive compensation should be retained.

I. Stock Option Expense

The Company claims that the decision regarding stock option expenses should be based on the same criteria as the incentive compensation recovery issue (NICOR BOE at 50). Staff and the PO both agree with this claim and therefore, the PO should retain the language regarding this issue consistent with the decision on incentive compensation.

J. Payroll Expense

The PO concluded correctly that test year operation and maintenance expense should be reduced by $502,000 for an adjustment to payroll expenses. (PO, pp. 48-49) As the PO noted, the evidence shows that headcount remained stable in the first quarter of the 2005 test year compared to 2004 levels. In the face of this, Nicor Gas failed to supply any documentation to support its claim that it would hire approximately 50 additional employees during the test year. The Commission should reject the substitute language proposed by Nicor Gas and retain the PO's language and adjustment reducing test year operating and maintenance expenses by $502,000.

K. Rate Case Expense

The Company's proposed substitute language rejecting Staff's eight year amortization period for rate case expense should be disregarded. The Company infers that Staff is being inconsistent in its proposal of an eight-year amortization period since the amortization periods for rate case expense in recent history have not been higher than five years. (Nicor BOE at 51-52) The Company fails to recognize that the *length* of the amortization period is not how one determines whether there has been consistency. Rather, it is the underlying *basis* for the amortization period that should be evaluated. That evaluation shows that Staff is indeed consistent with prior Commission decisions in its basis for the proposed amortization period. Using the examples cited by the Company, Staff demonstrates this to be true. (Staff IB, p. 51-53 and ICC Staff Exhibit 11.0 Revised, pp. 4-9, ll. 72-168)

The Company claims that Staff's proposal for an eight year amortization period for rate case expense ignores the use of a five year period in Nicor's 1995 rate case (Nicor BOE, p. 52). Staff clearly did consider the amortization period approved in the 1995 rate case as was discussed in Staff's Initial Brief:

> When comparing the Company's five year period to Staff's eight year period for rate case amortization, the Commission should consider the impact of choosing too short an amortization period. The Commission need only look back to the Company's most recent rate case. In that proceeding, the Commission approved a five-year amortization period which resulted in an annual rate case expense of $220,000 (ICC Staff Exhibit 11.0 Revised, Attachment A). Since those rates will soon have been in effect for 9 years, the Company has over-recovered 4 years of rate case expense or $880,000. Therefore, the five-year period approved was not conservative as the Company suggests. Given the Company's history in filing rate cases, it would be conservative and reasonable to amortize rate case expense over an eight-year period. (Staff IB, p.52)

The PO correctly considered the impacts to ratepayers of approving either too long or too short an amortization period for rate case expense and found that Staff's proposed eight year amortization period to be appropriate (PO, p. 51).

IV. RATE OF RETURN

A. 23 Basis Point Risk Adjustment

Nicor's BOE is fraught with mischaracterizations, misunderstandings, and outright inaccuracies with regard to the evidence presented concerning Nicor Gas' cost of capital.

The Company erroneously states that Staff's sample was derived using a standard of 70% of operating revenues from regulated operations. (Nicor BOE, p. 55) In actuality, Staff used a standard of 70% of operating revenues from regulated <u>gas</u> delivery operations. (ICC Staff Exhibit 5.0, p. 14) Although the Company seems to disregard this difference between its sample and Staff's sample, it is not insignificant. The record contains no evidence to demonstrate that the risk related to the <u>non-gas</u> utility operations, as the Company's sample reflects, is representative of the risk of <u>gas</u> utility operations, which Staff targeted and which this proceeding is attempting to price.

The Company also claims that the cost of Nicor Gas' AA corporate credit rating is already reflected in its of cost debt and, thus, concludes that it is not necessary to reflect that rating in its cost of equity. (Nicor BOE, p. 57) This claim displays a fundamental misunderstanding of the relationship between total risk and the cost of common equity. All capital components costs must reflect the total risk of the Company, which is reflected in its corporate credit rating. To reflect total risk in only one capital component is insufficient.

The Company states that the risk of Nicor Gas is already reflected in its CAPM and DCF estimates. (Nicor BOE, p. 57) The Company's argument demonstrates a misunderstanding of proxies. The risk reflected in the Company's CAPM and DCF estimates is the risk of the *sample companies* whose data was used in those analyses, not that of *Nicor Gas*. The Proposed Order concluded the sample is reasonably similar but not equivalent to that of Nicor Gas. Thus, it properly included a risk adjustment to more accurately reflect the risk of Nicor Gas.

The Company states that risk profiles are based on debt yields (Nicor BOE, p. 57) and that credit ratings are guideline ranges for credit rating agency purposes only. (Nicor BOE, p. 59) These statements betray of a fundamental misunderstanding of financial theory. First, debt yields are based on risk profiles, not the other way around. Second, credit ratings, and their associated yield spreads, are most certainly not guidelines for credit ratings agency purposes only. Credit ratings agencies publish credit ratings not for their own use, but for the use of any counterparty with which a rated company may interact as a means to gauge the rated company's risk; the associated yield spreads are based on actual quotes of yields associated with given ratings. (ICC Staff Exhibit 5.0, p. 30)

The Company implies that Nicor's AA credit rating, which Staff used to derive its 23 basis point adjustment, applies to specific bonds. (Nicor BOE, p. 59) However, Staff used corporate credit ratings, which reflect the general financial health of companies, as opposed to the default risk of any particular bond or class of bonds a company issues. (ICC Staff Exhibit 5.0, Schedule 5.6)

The Company implies that the business risk profile is the critical measure in determining the cost of capital. (Nicor BOE, p. 58) As Staff has explained, and the Company witness has acknowledged, <u>total</u> risk is the critical measure that drives the cost of capital. Business risk represents only a portion of total risk. (Staff BOE, p. 38)

The Company claims that its sampling process has already lowered its estimate of Nicor Gas' cost of equity from 11.49% to 10.82%. (Nicor BOE, p. 58) This claim is unsupported by the record. The 10.07% DCF estimate, the 12.91% CAPM estimate, and the resulting 11.49% estimate to which Nicor refers do not appear anywhere in Company witness Makholm's Rebuttal Testimony (Nicor Exhibit 21.0), which the Company erroneously cites as its source. In fact, Staff is unable to locate those estimates anywhere in the Company's testimony.

The Company argues that removing the four companies that did not meet Staff's 70% revenue from gas utility operations in 2004 would eliminate the need for a risk adjustment, since the average business profile score for the remaining four-company sample would equal that of Nicor Gas. Staff thoroughly refuted this argument previously in testimony. (ICC Staff Exhibit 14.0, p. 26) This argument is merely an attempt to garner a higher rate of return through a disingenuous, results-driven argument that conflicts with its own witness' position. Moreover, that argument is ineffectual, since it focuses solely on business risk and ignores the more crucial total risk; a risk adjustment would still be necessary based on total risk.

The Company argues that its sample is more representative of Nicor Gas than Staff's sample. In support of this claim, the Company points out that, using 2004 data, Staff's sample does not meet Staff's 70% revenue from gas utility operations criterion. (Nicor BOE, pp. 55-56) This is a curious argument, given that the Company's sample does not meet that criterion either. In fact, as fully explained in Staff's BOE, the record does not establish that any of the companies in Nicor's sample ever met that criteria. Further, given that the Company has not established that the risk related to the non-gas utility operations of its sample companies is representative of the risk of Nicor Gas' gas utility operations, and that Staff has shown that Staff's sample and Nicor's sample are very similar in terms of total risk, there is no reason to conclude that the Company's sample is superior to Staff's sample. To the contrary, the evidence indicates that Staff's sample is superior to the Company's. (Staff BOE, pp. 40-42)

In conclusion, for the reasons discussed above, the Proposed Order correctly determined that 23 basis point adjustment is necessary to properly reflect the risk of Nicor Gas. The Company's arguments to the contrary are unconvincing and should be rejected.

B. Flotation Costs

The Proposed Order correctly concluded that the Company has failed to substantiate its claims for recovery of equity flotation costs and therefore such costs should be denied. (PO, p. 93) In its BOE, the Company argues that the Proposed Order's denial of flotation costs was an error. For the reasons discussed below, the Company's arguments should be given no weight.

First, the Company states that "under the Proposed Order's theory, [Nicor] will never be able to recover any of [its unrecovered issuance costs]." (Nicor BOE, p. 60) This claim is without merit. The Proposed Order merely precludes the Company from recovering any issuance costs it may not have yet recovered until such time as the Company presents supporting documentation that demonstrates that such costs were incurred and remain unrecovered. The Company claims to possess documents demonstrating as much (Nicor BOE, pp. 60-62); it needs to provide them for the record.

Next, the Company wrongly implies that the burden of proof is on Staff to disprove its claims of unrecovered issuance costs rather than on the Company to substantiate those claims. (Nicor BOE, pp. 60-62) As the AG BOE correctly notes, the burden is on the Company to support its claims, as specified in Part 220 ILCS 5/9-201(c) of the Public Utilities Act. Nicor's argument confuses "claims" with "evidence." The Proposed Order correctly concluded, a mere claim does not constitute evidence, and claims are all the Company has provided.

The Company claims that it provided undisputed "evidence" that the flotation costs were incurred but not recovered and, therefore, under "the law of evidence", the Commission must grant Nicor recovery of these costs. (Nicor BOE, p. 60) Nicor's attempt to bolster its claim by referencing specific case law is misplaced. The cases cited do not provide the desired support for Nicor's claims. The Thigpen case, for example, involved a fireman (Thigpen) who sought administrative relief from the Retirement Board's denial of his application for disability benefits. Clifton Thigpen v. Retirement Board of Fireman's Annuity and Benefit Fund of Chicago, 317 Ill. App. 3d 1010; 741 N.E.2d 276 (1st Dist 2000). On appeal, the Court found that the Board's determination that the "evidence fails to establish" that the Applicant is disabled was itself "against the manifest weight of evidence." (id. at 1022) It should be noted that the "evidence" in question in Thigpen was comprehensive. By the Court's own description, this "evidence" included: Thigpen's February 22, 1995, emergency room report; the Chicago fire department's report of Thigpen's injury; Thigpen's duty disability benefit application and supporting statement; Thigpen's lay up summary; Dr. Mather's diagnostic evaluations and letters to the Chicago fire department's medical director; Dr.

Ike Arene's letter to the Board; Dr. Gettleman's letters to the Board's physician and consultant, Dr. George Motto and Dr. Arene; Dr. Motto's letter to the Board; Dr. Motto's curriculum vitae; reports regarding Thigpen's non-duty injuries and hospitalizations; medical reports regarding Thigpen's epidural injections, bone scan, and X-rays; Thigpen's work capacities assessment; three FCE reports; and the testimony of Rios, Dr. Motto, and Thigpen. Additionally, two eye-witnesses corroborated Thigpen's fall from the ladder at the firehouse and his good condition and strength prior to the fall.

The Company's attempt to use Thigpen as support for its argument against the Commission's denial of flotation costs is off point and misleading. The evidence in Thigpen (in terms of both quantity and probative value) makes that case clearly distinguishable from the case at hand.[1] As Staff has established, Nicor has simply failed to provide the evidence required to justify the recovery it seeks. As such, the Proposed Order correctly denied the recovery of these flotation costs.

The Company implies that by meeting the requirements of Part 285, it has met its burden of proof with regard to flotation costs. (Nicor BOE, p. 61) This is yet another inconsistency in the Company's case. In its BOE, the Company argued that Part 285 is merely a guideline that "does not establish substantive law or rules of decision." (Nicor BOE, pp. 91-92) In a complete reversal from that position, the Company protests that it does not need to submit into evidence the documents that it alleges would substantiate

[1] An additional fact that distinguishes Thigpen from the case at hand is that in Thigpen, the plaintiff was examined by the Board's own physician and consultant, who himself determined that plaintiff was unable to perform his duties as a fireman. Thus, The Board had the opportunity to collect independent affirmative evidence concerning the nature of Thigpen's injuries. Contrastingly in the instant case there is no way for Staff or other entities to independently confirm Nicor's claim.

its claims, since Part 285 does not require the filing of such documents. This is not only inconsistent, but false. 83 Ill. Adm. Code 285.4050(b) requires utilities seeking to recover common equity flotation costs to list those costs. 83 Ill. Adm. Code 285.4050(e) requires utilities to provide documents that show that the costs identified in 285.4050(b) have not been recovered. Further, there is no requirement that the Commission must accept the Company's unsubstantiated claims. Indeed, given that the burden of proof is on the Company, the Commission cannot accept unsubstantiated claims.

Finally, in response to the Proposed Order's concern that two of the five issuances from which Nicor derived its flotation cost estimate were issued by Nicor, Inc., the Company implies that it developed an unrecovered flotation cost estimate on a *percentage* cost basis that can be applied to its entire equity balance, making Nicor, Inc.'s involvement irrelevant. (Nicor BOE, p. 62) The Company is factually and logically mistaken, as was fully explained in Staff Reply Brief. (Staff RB, p. 69)

In light of the above, the Proposed Order's denial of flotation cost recovery should be maintained.

C. Technical Correction

Nicor's BOE acknowledges the Proposed Order's finding that Nicor Gas is not entitled to the recovery of flotation costs, but notes that Appendix A to the Proposed Order does not reflect that finding. The Company states that incorporating that disallowance would reduce the proposed rate of return from 8.90% to 8.87%. (Nicor BOE, p. 63 and Exhibit 2) Staff disagrees. The correct adjustment to remove flotation costs from the cost of equity adopted in the Proposed Order would reduce the proposed rate of return from 8.90% to 8.85%, as fully explained in Staff's BOE. (Staff BOE, pp. 65-66) The difference between Staff's correction and that proposed by the Company is that the Company's proposal fails to remove the flotation costs it imbedded in its CAPM analysis, whereas Staff removed flotation costs from both the DCF and CAPM analyses. The Company's failure to remove the flotation costs from its CAPM analysis causes it to understate the necessary correction, leading to an overstated final cost of capital. For this reason, and the reasons presented in Staff's BOE, if the Commission were to only correct the flotation cost error, the Proposed Order's cost of common equity must be adjusted downward by 8 basis points to 10.51%.

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

A. Cost Of Service Study

The Illinois Industrial Energy Consumers ("IIEC") takes exception to the PO's allocation of Nicor's gas transmission and distribution ("T&D") costs according to Average and Peak ("A&P") rather than the Coincident Peak ("CP") approach that IIEC favors. (IIEC BOE, pp. 3-5) In this regard, IIEC ignores the significant role that everyday availability and usage of the Nicor system plays in the existence of the system, focusing instead on the partial connection that increased volumes and demands play in the cost of the system. If utilization of the Nicor gas distribution system was limited to a few peak days or weeks each year, (e.g., as the CP approach to allocation suggests) the cost to install the system would be prohibitive, and rates to use the system on only a few peak days or weeks would be similarly prohibitive. As Staff explained in its Initial Brief, while there is likely some incremental cost that results from building a system to meet peak demand rather than average demand, no party has shown that there is a direct, proportionate correlation between the level of demand and the level of costs to install, operate, and maintain a distribution system to meet different levels of demand. (Staff IB, pp. 104-105, Staff RB, pp. 77-78) IIEC has not shown that the cost to install, operate, and maintain Nicor's system to meet peak demand is four times the cost to install, operate, and maintain a system sized to meet average daily demand that is one-fourth peak demand. Therefore, IIEC's argument, that if Nicor relied on A&P to size its system, the system would be inadequate, suffers from a lack of evidence (IIEC BOE, pp. 3-4)

IIEC's comparison to the allocation of meters is similarly irrelevant. (Id., p. 4) A meter, unlike distribution mains and supporting equipment, is installed at the service connection for each customer and is therefore customer specific. The cost to install, operate, and maintain similar-sized meters is determined, and then each customer within a given customer class is charged the average cost of similar meters. The T&D system, however, represents common costs because it is used by all customers. It is appropriate to allocate costs to various customer classes based upon their relative use of the mains, and weight the relative importance of average usage throughout the year of distribution mains that are available and in-use throughout the year with use on a few peak days or weeks during the year.

By approving A&P in previous general gas distribution rate dockets, the Commission has properly recognized that customers who more heavily use the distribution system on average throughout the year than other customers should pay for at least some of the cost to install, operate, and maintain the system based upon that heavier usage. A&P balances the roles that average usage and peak demand play in the cost to install, operate, and maintain the Nicor gas distribution system. The Commission should reject IIEC's continued focus on CP to allocate T&D costs and accept the Proposed Order's recommendation to apply A&P in this docket.

B. Rates, Riders, and Other Terms

1. Rate 1

The Citizens Utilities Board and Cook County States Attorney's Office ("CUB/CCSAO") support the PO's recommendation to continue Nicor's current declining 3-block distribution charge for Rates 1, 4, and 74. (CUB/CCSAO BOE, pp. 40-44) CUB/CCSAO contradicts itself by explaining that Nicor's distribution charges under Rates 1, 4, and 74 "will maintain consumption efficiency incentives embedded within Nicor's proposal, while preserving gradualism in the move towards a flat-rated demand charge." (Id., p. 41) The contradiction occurs with the conclusion that Nicor's distribution charges contain consumption efficiency incentives compared to a flat-rated demand charge, which for Rates 1 and 4 should be termed a volume charge rather than a demand charge. The contradiction continues with the support of a declining 3-block distribution charge structure with efficiency in explaining that "front-loaded rates have the effect of discouraging efficient consumption by customers." (Id., p. 42) Since a declining distribution charge structure is an example of front-loaded rates because demand and volumetric costs are recovered at a faster pace through the lower levels of usage compared to higher volumes, CUB/CCSAO's argument contradicts a continuation of a declining distribution charge structure.

As Staff explained in its Initial Brief, Reply Brief, and Brief on Exceptions, a reduced tail block sends an inappropriate price signal that high-volume gas usage costs less per therm to distribute than low-volume gas usage. (Staff IB, pp. 116-117; Staff RB, p. 81; and Staff BOE, pp. 72-73) Demand costs, which are recovered from Rate 1 and Rate 4 customers through the volumetric distribution charge, are allocated according to levels of demand. Increased demand from a given customer would be billed through the distribution charge applicable to the highest volume of billing for that customer. A declining volumetric distribution charge would send the pricing message that higher volumes of gas usage are less expensive to deliver than lower volumes of gas usage because the highest volumes of gas usage would be billed at the lowest rate per therm. If sufficient numbers of customers under Rates 1, 4, and 74 follow that pricing message, Rates 1, 4, and 74 would be allocated higher percentages of demand costs because of higher demands and volumes not controlled by appropriate pricing, and it is possible Nicor would then be required to install additional capacity to serve those same customers, thereby incurring more costs to serve the same customers. A higher cost to serve the same customers does not meet Staff's understanding of efficiency.

CUB/CCSAO also refer to rate shock in apparently describing the effects that Staff's nearly flat distribution charge would have on some customers. As Staff explained in its Initial Brief and Reply Brief, the 2.57¢ per therm difference between Staff's highest volume distribution charge under Rate 1 compared to Nicor's proposed charges cannot be termed rate shock when compared to the 35+¢ per therm increase in the cost of the supply of gas that has occurred over the past few years. (Staff IB, p. 114, and Staff RB, p. 81) The difference between Staff's highest volume Rates 4 and 74 compared to Nicor's proposed charges is even smaller at 0.17¢ per therm and 0.77¢ per therm, respectively. It is true that higher volume customers would incur a greater distribution charge increase under Staff's proposed rate design for Rates 1, 4, and 74, but it is appropriate that higher volume customers incur a greater percentage of demand and volumetric costs under a nearly flat distribution charge structure as compared to the current declining 3-block distribution charge structure. This is because demand and volumetric costs are allocated according to levels of demand and volume. Since higher levels of demand and volume result in a higher allocation of demand and volumetric costs, the increase in billings for higher volumes should mirror the increase in cost allocation resulting from increases in demand and volume. This is particularly so if rate shock is not evident when considering the far-greater increased cost of the supply of the natural gas being distributed. The Commission should amend the PO so that distribution charges under Rates 1, 4, and 74 would be nearly the same per therm for high volumes of usage as low volumes of usage, as recommended by Staff.

2. Rider 6

a. Commodity Portion of Uncollectibles

The PO concluded correctly that commodity-related uncollectibles expense should not be included in Rider 6, Nicor Gas' PGA Clause, but should, instead, continue to be recovered through base rates. (PO, p. 180) The evidence demonstrates that uncollectibles are a normal cost of providing service and do not warrant special treatment through a rider. Therefore, the Commission should reject the substitute language proposed by Nicor Gas which would permit recovery of uncollectibles expense through the PGA. Such a finding is contrary to the weight of evidence about Nicor Gas' uncollectibles expense that has been presented in this proceeding.

Nicor Gas disagrees with the PO's conclusion. (Nicor BOE, pp. 88-92) It asserts that recovery of uncollectibles through the PGA clause is consistent with Section 9-220(a) of the Public Utilities Act ("Act") and 83 Ill. Adm. Code 525. (Nicor BOE, p. 90) Nicor Gas also asserts that the drivers, volatility, and significance of its uncollectibles expense meet the criteria for a rider. (Nicor BOE, pp. 89, 91) Further, it asserts that many state public utility commissions have concluded that it is appropriate to recover uncollectible expenses through a rider or "tracker." (Nicor BOE, p. 92)

The Commission should not be swayed by Nicor Gas' arguments. The PGA is for the limited purpose of changing rates based upon changes in the cost of purchased gas. (ICC Staff Exhibit 1.0, pp. 16-18, ll. 311-388) Uncollectibles expense is not an unrecovered cost of purchased gas. Rather, it is a cost of doing business on something other than a cash-only basis. Therefore, uncollectibles should not be passed through the PGA. (ICC Staff Exhibit 1.0, pp. 13-15, ll. 254-310) Furthermore, the evidence demonstrates that Nicor Gas's uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider. Therefore, Nicor Gas' uncollectibles expense should not be separated out from other test year operating expenses to be given special treatment through the PGA. (ICC Staff Exhibit 1.0, pp. 18-26, ll. 389-503) Finally, Nicor Gas' appeal to the decisions of other state commissions does not avail. Illinois decisions must be based upon Illinois law and the decisions in this case must be based upon the evidence in this case.

The Company argues that its proposal to recover what it calls the commodity-related portion of its uncollectibles through the PGA is consistent with Section 9-220 of the Public Utilities Act ("Act") and 83 Ill. Adm. Code 525 ("Part 525") of the Commission's rules. (Nicor BOE, pp. 90-91) In doing so, the Company emphasizes the word "collected" as it is used in one sentence of Section 9-220. (Nicor BOE, p. 90) However, the Company fails to note that its interpretation is inconsistent with the way in which the Commission has applied Section 9-220 and Part 525 previously. Furthermore, the Company's interpretation of Section 9-220 is inconsistent with its own proposal in this proceeding. Finally the Company's interpretation is inconsistent with the way in which Nicor Gas has proposed, and the Commission has approved, the Company's PGA reconciliations. It is not a simple matter of emphasizing a single word. One must understand that word in its context and one's interpretation must be informed by the technical issues that underlie its application.

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

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

The Company also asserts its commodity-related uncollectibles expenses independently meet the criteria for a rider, given their amount, drivers, and volatility. (Nicor BOE, pp. 89, 91) The evidence simply contradicts the Company's assertion. Staff presented evidence and analysis that Nicor Gas's uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider. Therefore, Nicor Gas' uncollectibles expense should not be separated out from other test year operating expenses to be given special treatment through the PGA.

The evidence demonstrates Nicor Gas' uncollectibles expense is not a significant expense when compared to Nicor Gas' other operating expenses, excluding purchased gas costs. (ICC Staff Exhibit 1.0, p. 19, ll. 401-421) Figure 1 compares Nicor Gas' uncollectibles expense with the total of all other operating expenses, excluding purchased gas costs. (ICC Staff Exhibit 1.0, p. 20)

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

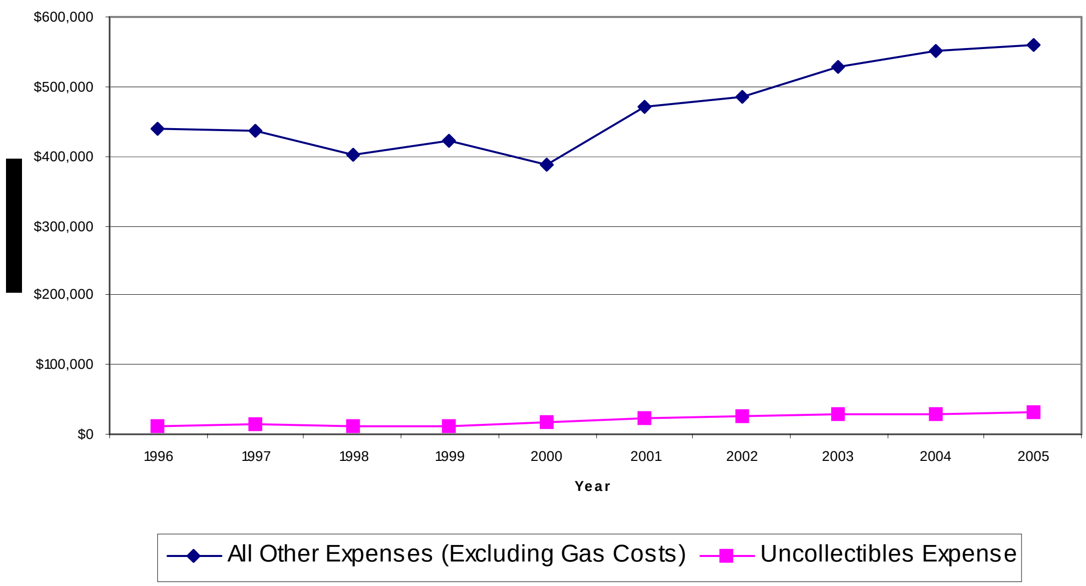


Figure 1 demonstrates that Nicor Gas' uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider like the PGA.

The evidence also demonstrates Nicor Gas' uncollectibles expense has not been fluctuating more than the other expenses. Figure 2 demonstrates that the magnitude of change in other expenses, excluding purchased gas costs, has been greater than the magnitude of change in uncollectibles expense. (ICC Staff Exhibit 1.0, p. 21)

Figure 2
***Change* in Uncollectibles Compared to *Change* in All Other Expenses (Excluding Gas Costs)**

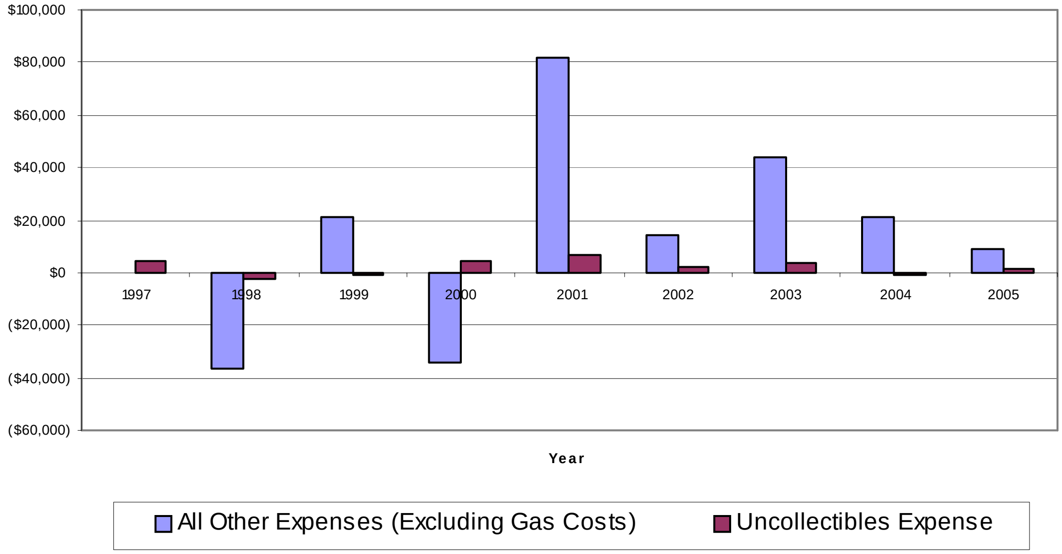
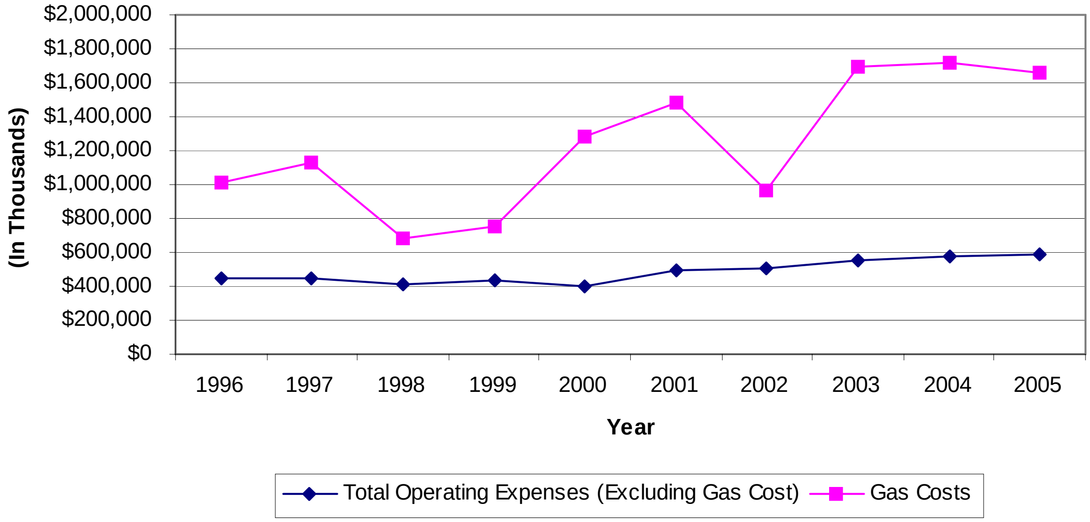


Figure 2 demonstrates that Nicor Gas' uncollectibles expense does not fluctuate significantly in comparison to the overall operating expenses in a way that warrants special treatment through a rider like the PGA.

By way of comparison, purchased gas costs both stand out and fluctuate significantly in comparison to other operating expenses. Figure 3 compares Nicor Gas' purchased gas costs with the total of all its other operating expenses for the years 1996 through the 2005 test year. (ICC Staff Exhibit 1.0, p. 22)

Figure 3
Gas Costs Compared to All Other Expenses



This is one of the reasons a rider, the PGA, is warranted for purchased gas costs. The Commission noted this when revising Part 525:

> The purpose of this proceeding is to revise Part 525 which is the tracking mechanism designed to allow utilities to recover, dollar for dollar, their cost of gas. Due to the fluctuation of gas costs, a tracking mechanism such as the PGA is necessary to avoid frequent rate cases. The PGA allows utilities to adjust their rates to recover gas costs without the need for frequent rate proceedings. (Commission Order, Docket No. 94-0403 dated August 23, 1995, p. 2)

While it is correct that Nicor Gas' uncollectibles expense fluctuates from year to year when compared to itself in isolation, Nicor Gas' uncollectibles expense is not volatile and fluctuating when compared to the rest of the operating expenses. Uncollectibles expense should remain in the test year so it will be considered in the aggregate with the other components of the revenue requirement for the purpose of setting rates. Uncollectibles expense should not be separated out from other test year expenses and recovered through a separate rate that changes in between rate cases without considering changes in other components of the revenue requirement formula.

Therefore, the Commission should continue to include uncollectibles expense in the Company's test year. (ICC Staff Exhibit 1.0, pp. 21-23, ll. 427-541)

Nicor Gas also asserts that many state public utility commissions have concluded that it is appropriate to recover uncollectible expenses through a rider or "tracker." (Nicor BOE, p. 92) The decisions in jurisdictions outside Illinois simply have no relevance here given that Nicor's proposal is inconsistent with Illinois law as discussed above. Commission decisions must be based upon Illinois law and the decisions in this case must be based upon the evidence in this record. As demonstrated above, the evidence in this proceeding demonstrates that Nicor Gas's uncollectibles expense does not stand out in comparison to the overall operating expenses in a way that warrants special treatment through a rider. Therefore, the PO got it right, based upon the evidence in this case, when it found that Nicor Gas "did not meet its burden of showing that these costs are of a nature that should be recovered through a rider rather than base rates." (PO, p. 180)

VI TECHNICAL CORRECTIONS

Nicor Gas, in Exhibit 2 to its Brief on Exceptions, indicates that it has reviewed the Proposed Order's Appendix A and has identified certain items it believes are corrections and omissions. Staff has reviewed these items and provides the following response.

A. Budget Payment Plan – Interest Expense

Staff agrees that an adjustment should be included for the budget payment plan adjustment's impact on the associated interest expense. However, Staff disagrees with Nicor Gas about the amount. The interest expense adjustment should be $1,428,000 as shown on AG Exhibit 1.3, Schedule B-4, rather than the $1,446,000 amount indicated by Nicor Gas.

B. Customer Deposits – Interest Expense

Staff agrees that an adjustment should be included for the customer deposits adjustment's impact on the associated interest expense. Staff also agrees with Nicor Gas that amount of the adjustment is $477,000. This amount is set forth on AG Exhibit 1.3, Schedule C-2.

C. Gross Utility Plant Adjustments

<u>Depreciation Expense:</u> Staff agrees that the adjustment for depreciation expense is derivative of the adjustments to gross utility plant. However, Staff disagrees with Nicor Gas that the amount that corresponds to the PO's other findings is $109,000. Staff believes the amount that corresponds to the PO's other findings is $124,000. Attachment A to this Reply Brief on Exceptions computes the correct depreciation expense adjustment under various scenarios proposed in the case. The $109,000 amount proposed by Nicor Gas would be correct if the Commission uses an average rate base and reduces plant additions by -0.8%. This calculation is shown on page 2 of Appendix A. However, the PO used a year-end rate base and reduced plant additions by -0.8%. The correct depreciation expense adjustment for that scenario, as shown on

page 1 of Appendix A, is $124,000. The $124,000 amount is the one that is consistent with the PO's other findings. Both Staff and Nicor Gas disagree in part with the PO's findings, as is discussed in the respective Briefs on Exceptions.

Accumulated Depreciation: Staff agrees that the adjustment for accumulated depreciation expense is derivative of the adjustments to gross utility plant. However, Staff disagrees with Nicor Gas that the amount that corresponds to the PO's other findings is $268,000. Staff believes the amount that corresponds to the PO's other findings is $283,000. The derivation of both these amounts is presented in Appendix A to Staff's Brief on Exceptions. The $268,000 amount proposed by Nicor Gas would be correct if the Commission uses an average rate base and reduces plant additions by -0.8%. This calculation is shown on page 2 of Appendix A to Staff's Brief on Exceptions. However, the PO used a year-end rate base and reduced plant additions by -0.8%. The correct depreciation expense adjustment for that scenario, as shown on page 1 of Appendix A to Staff's Brief on Exceptions, is $283,000. The $283,000 amount is the one that is consistent with the PO's other findings. Both Staff and Nicor Gas disagree in part with the PO's findings, as is discussed in the respective Briefs on Exceptions.

D. Interest Synchronization

Staff agrees that the above corrections to rate base will have a slight impact upon the interest synchronization adjustment.

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,

/s/______________________________

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