STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	No. 07-____
Proposed General Increase	:	
In Rates For Gas Service	:	

Direct Testimony of

LAWRENCE T. BORGARD

President and Chief Operating Officer - The Integrys Gas Group
and
Vice Chairman of the Board and Chief Executive Officer -
The Peoples Gas Light and Coke Company and
North Shore Gas Company

On Behalf of
North Shore Gas Company

March 9, 2007

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I. INTRODUCTION AND BACKGROUND

A. Witness Identification

Q. Please state your name and business address.

A. Lawrence T. Borgard, 130 East Randolph Drive, Chicago, Illinois 60601.

Q. By whom and in what position are you employed?

A. I am President and Chief Operating Officer of Integrys Gas Group and Vice Chairman of the Board and Chief Executive Officer of North Shore Gas Company and The Peoples Gas Light and Coke Company.

B. Purposes of Testimony

Q. What is the purpose of your direct testimony in this proceeding?

A. The purpose of my direct testimony is to discuss the reasons North Shore Gas Company ("North Shore" or "the Company") finds it necessary to request a rate increase (the first rate increase it has requested in twelve years), to propose rate design changes at this time, and to describe certain of the innovative rate design proposals that the Company is making in this filing. Those points are addressed in Section II of my testimony.

I also identify the other witnesses providing direct testimony in support of the Company's filing and provide a short overview of the subjects on which they will testify in Section II of my testimony.

I discuss in more detail the key components of North Shore's rate design proposals in Section III of my testimony.

Finally, I note that the Company's rate filing conforms with the agreements and orders entered in other proceedings, in Sections IV and V of my testimony.

C. Summary of Conclusions

Q. Please summarize the conclusions of your testimony regarding North Shore's need for a rate increase.

A. The facts demonstrate that North Shore is not recovering its costs (including capital costs and operating expenses) incurred in order to provide safe, adequate, and reliable natural gas distribution service to its customers. In order to be able to continue to provide customers with safe, adequate, and reliable natural gas distribution service, the Company is seeking an increase in its base rates of $4,772,000, if its proposed uncollectible account expenses rider is approved, or $6,314,000 if that rider is not approved.

Q. Please summarize your testimony regarding North Shore proposed rate design changes.

A. North Shore has made a number of rate design proposals that are necessary to update and augment its Schedule of Rates for the benefit of its customers and the Company. North Shore is proposing increases in its base rates to achieve a more equitable recovery of costs balanced by the impact on customers. The Company is also making changes to its transportation services that reflect the changes over the last 12 years in how these services operate. In addition, North Shore is proposing certain riders that better balance benefits and costs between the Company and its customers.

D. Itemized Attachments to Direct Testimony

Q. Are there any attachments to your direct testimony?

A. Yes. The following exhibits were prepared by me or under my supervision and direction:

(1) North Shore Exhibit ("Ex.") LTB-1.1 shows the monthly NYMEX natural gas prices and North Shore monthly gas charge for the past 13 years;

(2) North Shore Ex. LTB-1.2 shows the continual decline in the usage of residential heating customers over the past 12 years;

(3) North Shore Ex. LTB-1.3 shows the monthly degree day variation from normal and the annual degree day variation since 1995 (this variation is shown versus the Company's proposed 10 year normal);

(4) North Shore Ex. LTB-1.4 shows the Company's actual bad debt (uncollectible account) expense for fiscal years 1995 through 2005; and

(5) North Shore Ex. LTB-1.5 shows the Conditions of Approval from the order of the Illinois Commerce Commission (the "Commission" or "ICC") in ICC Docket No. 06-0540, which bear on this filing.

E. <u>Background and Experience</u>

Q. What are your duties in your position with Integrys Gas Group?

A. As President and Chief Operating Officer of Integrys Gas Group, I am responsible for all the natural gas businesses for the parent company, Integrys Energy Group, Inc. This group is made up of The Peoples Gas Light and Coke Company ("Peoples Gas"), North Shore Gas Company, Minnesota Energy Resources Corporation, and Michigan Gas Utilities Corporation. In this position I am responsible for operations, engineering, marketing, customer contact, payment processing, credit and collections.

Q. Please summarize your professional experience.

A. I began my career with Integrys in 1984 as an Associate Engineer and subsequently served as Electric Engineer, Planning Engineer, Division Engineer, Transmission Planning Engineer, Regulatory Compliance Supervisor, Manager – Transmission Planning and Operations, and General Manager – Transmission, before being appointed

Vice President – Transmission in 1999, Vice President – Transmission and Engineering in 2000, Vice President – Distribution and Customer Service in 2001 and President and Chief Operating Officer – Energy Delivery in August 2004. I was appointed President of Upper Peninsula Power Company in 2002, Chief Executive Officer in May 2004, and President and Chief Operating Officer of Integrys Gas Group in February 2007.

Q. Please summarize your educational background.

A. I received a Bachelor of Science degree in Electrical Engineering from Michigan State University in 1984 and a Masters Degree in Business Administration from the University of Wisconsin – Oshkosh in 1995. I am also a 2002 graduate of the Harvard Business School's Advanced Management Program.

Q. Have you ever testified before the Commission?

A. Yes, I have testified in ICC Docket No. 06-0540 regarding the merger of Peoples Energy Corporation, the parent company of North Shore, and WPS Resources Corporation, to form Integrys Energy Group, Inc., which is now the parent of Peoples Energy. I have also testified in numerous dockets before the Public Service Commission of Wisconsin.

II. SUMMARY OF NORTH SHORE'S NEED FOR RATE RELIEF AND RATE DESIGN CHANGES

A. Overview

Q. Please give a brief description of the operations of North Shore.

A. The Company is engaged in the business of transporting, purchasing, storing, distributing and selling natural gas at retail to approximately 158,000 residential, commercial, and industrial customers within the fifty-four communities in Lake and Cook Counties, Illinois. The Company owns a 2,270 mile distribution system and serves one of the fastest growing regions in the state of Illinois while sharing many administrative facilities owned by Peoples Gas. The Company employs approximately 200 people. North Shore is a wholly owned subsidiary of Peoples Energy Corporation which is a wholly owned subsidiary of Integrys Energy Group, Inc.

Q. In brief, what are the purposes of the Company's rate filing?

A. North Shore is requesting an increase in its current base rates and is proposing several new rate mechanisms in its tariffs. Together, they will allow the Company the opportunity to recover its current cost of service and earn a reasonable rate of return of and on its investment dedicated to providing gas service to its customers in Lake and Cook Counties, plus provide customers with new programs and rate mechanisms to mitigate the effects of weather and gas prices on their gas bills. The Company also is proposing changes to improve its current transportation programs.

B. Identification of Other Witnesses Providing Direct Testimony

Q. Please identify the witnesses presenting direct testimony in support of the Company's filing and the main topic(s) that each witness addresses.

A. The following witnesses are providing direct testimony on behalf of North Shore:

- Linda M. Kallas, Vice President, Financial and Accounting Services (North Shore Ex. LK-1.0), addresses and supports the Company's actual costs incurred during the test year being employed in this proceeding, fiscal year 2006 (October 1, 2005, through and including September 30, 2006). She discusses variances in operating expenses from the prior fiscal year and certain specific expenses in detail. She also addresses and supports certain ratemaking adjustments.

- Salvatore Fiorella, Manager, State Regulatory Affairs (North Shore Ex. SF-1.0), addresses and supports components of the Company's request for a general increase in rate base, including the test year, the revenue requirement, rate base, adjustments to rate base, operating income, and adjustments to operating income. He also addresses and supports the test year depreciation expense.
- Edward Doerk, Vice President, Gas Operations (North Shore Ex. ED-1.0), addresses and supports certain major additions to rate base since the last rate case and discusses and supports the Company's capital investment in operating assets.
- Michael J. Adams, Director in the Energy Practice of Navigant Consulting (North Shore Ex. MJA-1.0), addresses the Company's cash working capital requirements.
- Bradley A. Johnson, Vice President and Treasurer (North Shore Ex. BAJ-1.0), addresses the Company's capital structure and cost of capital (its required rate of return of and on its investments).
- Paul R. Moul, Managing Consultant, P. Moul & Associates (North Shore Ex. PRM-1.0), addresses the Company's required rate of return on common equity.
- Brian M. Marozas, Coordinator, Trading Risk Management (North Shore Ex. BMM-1.0), addresses the statistical support for using a recent 10-year, rather than a 30-year, period of data to develop the Company's normal heating degree days for purposes of weather normalization.

- Dr. Eugene S. Takle, Professor, Iowa State University (North Shore Ex. EST-1.0), addresses climate science data that support the reasonableness of Mr. Marozas' statistical study.
- Valerie H. Grace, Manager, Rates (North Shore Ex. VG-1.0), addresses and supports the Company's proposed rate design, except for the transportation riders, new riders that the Company is proposing, and changes to the Company's Schedule of Rates for Gas Service. She also addresses and supports the weather normalization adjustment to volumes.
- Thomas E. Zack, Vice President, Gas Supply (North Shore Ex. TZ-1.0), addresses and supports the proposed changes to the Company's small and large volume transportation programs and the associated tariff provisions.
- Ronald J. Amen, Director in the Energy Practice of Navigant Consulting (North Shore Ex. RJA-1.0), presents and supports the Company's embedded cost of service study.
- Russell A. Feingold, Managing Director in the Energy Practice of Navigant Consulting (North Shore Ex. RAF-1.0), addresses and supports three new riders that the Company is proposing to track certain costs and describe how other utilities and other states have addressed similar proposals.
- Ilze Rukis, Manager, Alternative Resources (North Shore Ex. IR-1.0), addresses and supports the Company's proposed energy efficiency and conservation programs.

C. <u>Need For Rate Relief and Rate Design Changes</u>

Q. When was North Shore's last authorized a general increase in its rates for gas service?

A. North Shore was last authorized a general increase in rates for gas service in the Order in ICC Docket No. 95-0031, entered November 8, 1995 ("1995 Rate Order"). The base rates authorized by the 1995 Rate Order became effective on November 14, 1995, and the transportation tariffs became effective on May 1, 1996.

Q. What was the rate of return of and on rate base authorized in the 1995 Rate Order?

A. The Commission authorized an overall rate of return of and on rate base (weighted average cost of capital) of 9.75%. The rate of return calculation incorporated an allowed rate of return on common equity of 11.30%.

Q. What is the amount of the revenue increase that the Company is requesting in this proceeding?

A. The Company is requesting an increase in its base rates of $6,314,000 in additional annual revenue exclusive of additional charges for revenue taxes, if its proposed uncollectible account expenses rider is not approved. The Company must recover its uncollectible account expenses through its base rates absent the rider. This is approximately a 2.2% increase in overall revenues. The Company is requesting an increase in its base rates of $4,772,000 in additional annual revenue exclusive of additional charges for revenue taxes, assuming that its proposed uncollectible account expenses rider is approved. Mr. Fiorella presents the development of this request in his testimony (Fiorella Direct, North Shore Ex. SF-1.0).

Q. During the past several years, has North Shore been able to earn a reasonable rate of return on average common equity?

A. While North Shore has earned close to its allowed return on equity, its return was lower in fiscal year 2006. In fiscal year 2004, North Shore actual earned rate of return on average common equity was 10.7%. In fiscal year 2005, North Shore actual earned rate of return on average common equity was 11.0%. In fiscal year 2006, excluding the effect of the settlement of North Shore 2001-2004 gas charge cases, North Shore actual earned rate of return on average common equity was 9.1%. All of these returns are below North Shore's allowed rate of return on equity of 11.30% from its last rate case and also below its request in this case of 11.06%. I should note that the Company's fiscal year, for accounting and financial reporting purposes, until December 2006 was the 12 months ending September 30. It is now a calendar year.

Q. Why is North Shore unable to earn a reasonable rate of return on common equity?

A. Two major factors have contributed to the Company's recent results and, in particular, its inability to earn a reasonable rate of return on common equity. These major factors are: (1) an increase in operating expenses and (2) the costs of increased investment in the Company's facilities to serve customers.

Q. Please describe the increase in operating expenses.

A. The Company has expended significant effort to reduce its costs of doing business. However, in a service territory which has had significant growth, the Company has seen its operating costs related to customers increase. As will be discussed later in my testimony the cost of bad debt has also increased for many reasons. In addition, like every other company that provides benefits to its employees, the Company has seen the cost of employee benefits increase substantially. Also, the amount that North Shore is billed through intercompany billing increased since its last rate case.

Q. How has the Company controlled its costs in order to delay the need to file a rate increase?

A. The Company has taken several significant steps to control costs. These efforts have enabled the Company to avoid increasing rates for the last decade. These cost control efforts are evident in several areas.

The Company has made numerous improvements in its operations that have created efficiencies. North Shore has employed new technology that has improved operations, such as using directional boring, external sealant, and vacuum trucks. Moreover, the Company's system maps are computerized, the new Supervisory Control and Data Acquisition ("SCADA") system automatically monitors the gas system and the new customer information system provides the call center representatives access to all available customer information. These improvements have created efficiencies that allow North Shore to operate and maintain its system with fewer employees than were required in 1995.

Q. What has occurred with bad debt expense over this period of time?

A. Bad debt expense is directly affected by the cost of gas. As is demonstrated by North Shore Ex. LTB-1.1, page 2, the cost of gas has more than doubled since the last rate case. High and volatile gas prices have an effect on certain customers' ability to make timely payments for services, or in some cases to pay at all, and have caused bad debt expense to rise. One particularly severe impact of this situation is that although gas costs are supposed to be a "pass through" cost item that does not affect the Company's return either positively or negatively, in fact the Company bears the burden of non-payment of the gas charge portion of customer bills. This results in the Company bearing the cost of a portion of the gas that is supplied to customers but not paid for. Bad debt expense on the gas charge portion of customer bills directly and adversely impacts the Company's ability to earn a just and reasonable rate of return on its investment.

Q. Has any other particular expenses changed significantly since the last rate case?

A. Yes, pension expenses and intercompany billings have increased significantly since the last rate case. Overall the cost of providing benefits to employees has increased significantly in the last few years. North Shore has also seen an increase in the level of billings it receives from Peoples Energy and Peoples Gas. Ms. Kallas will discuss this in her testimony (Kallas Direct, North Shore Ex. LK-1.0).

Q. Please discuss the increased investment in the Company's facilities.

A. North Shore has an ongoing need to invest in facilities to keep the Company's distribution system safe, adequate, and reliable and to provide customer service. Since 1995, North Shore has invested nearly $110 million in both new and replacement facilities. Much of this investment was due to the development of new businesses and subdivisions. Investment in distribution plant which includes mains, meters, and services was over 70% of the total capital investment since 1996 This investment has raised the Company's total capital investment and the need for a related return on this investment. In light of the long-lived nature of much of the Company's underground plant, such as mains and services, the installed cost of facilities constructed to replace existing facilities substantially exceeds the original cost of the facilities being retired. As a result of the Company's investments in facilities since the 1995 Rate Order, the Company's rate base has substantially increased.

Q. Has this growth in rate base caused a like increase in depreciation expense since the last rate case?

A. No, in fact, the requested depreciation expense in this case is approximately $1.4 million less than that allowed in the last rate case. This is due to the fact that in the intervening years North Shore has conducted studies of the lives of its plant that indicate that certain lives should be extended. These studies have been filed with the Commission and approved for use in determining depreciation expense. Thus depreciation expense is lower even though the continuing investment in plant has increased the rate base used to provide service to customers.

Q. How do these two factors you discussed impact this proposed rate increase?

A. North Shore's operating expenses, including bad debt expense, depreciation and taxes in the test year fiscal year 2006 as adjusted for ratemaking adjustments is $10 million higher than the level of expenses reflected in current rates. Ms. Kallas presents testimony and exhibits covering North Shore's actual operating costs and expenses for fiscal year 2006, the test year (Kallas Direct, North Shore Ex. LK-1.0).

With respect to investments in plant, which has totaled nearly $110 million since the 1995 Rate Order, the Company's original cost rate base for the test year fiscal year 2006 has increased by $19 million. This increase in rate base generates $3.1 million of the requested revenue increase. North Shore's original cost rate base as adjusted for the test year is presented in the testimony and exhibits of Mr. Fiorella (Fiorella Direct, North Shore Ex. SF-1.0). A discussion of the major capital projects reflected in this filing and the investment needed to serve customers is contained in the direct testimony of Mr. Doerk (Doerk Direct, North Shore Ex. ED-1.0).

Q. Are there any offsets that affect the revenue requirement?

A. Yes, partially offsetting the revenue increase generated by the increase in investment and operating expenses is a decrease in North Shore's overall average cost of capital. This decrease in overall cost of capital is due in part to decreased debt costs. The weighted average cost of capital for the fiscal year 2006 test year includes an embedded cost of long-term debt of 5.42%, as opposed to the 7.70% reflected in the Commission's 1995 Rate Order – or a reduction of 30%. Mr. Johnson discusses the activity undertaken to decrease debt costs in his testimony (Johnson Direct, North Shore Ex. BAJ-1.0). In addition, in this rate case filing North Shore is requesting a return on equity which is lower than the 11.30% allowed by the Commission in its last rate case. Mr. Moul supports the Company request of a return on equity of 11.06%. (Moul Direct, North Shore Ex. PRM-1.0) Overall, the Company's requested rate of return of and on rate base is 8.57%; which is 118 basis points lower than that allowed in the 1995 Rate Order. The lower requested rate of return as compared to the current authorized rate of return reduces the test year revenue requirement by $3.9 million.

In addition, the growth in the Company's customer base has increased its revenues overall, so the revenue requirement required in this case is also reduced by $2.9 million compared to the 1996 case. However, these customers are conserving more gas each year leading to a decline in throughput.

Q. Have there been changes in the Company's service territory in the last 10 years?

A. Yes, the Company's service area is one of the fastest growing areas in Illinois. However, growing numbers of residential heating customers do not translate into steady or growing throughput or load on the system. Overall, the Company has experienced significant residential load loss since the last rate case filing due to a number of factors. Deliveries have been negatively impacted by both weather and by reduced usage per customer. The Company's current rates were set based on volumes assuming 30-year normal weather. Because a large part of the Company's revenues and cost recovery are driven by volumetric-based charges, when weather is warmer than that 30-year normal, the Company's ability to earn a reasonable rate of return on its investment is directly and adversely impacted. Mr. Marozas demonstrates that a 10-year, rather than a 30-year, period of data should be used to develop the Company's normal heating degree days for purposes of weather normalization (Marozas Direct, North Shore Ex. BMM-1.0). Dr. Takle discusses the warming trend in weather, which makes continued use of the 30-year normal inappropriate for ratemaking purposes (Takle Direct, North Shore Ex. EST-1.0).

In addition to lower volumes due to the trend of warmer weather, the Company has experienced a significant decline in usage per customer. In recent years, natural gas prices have been trending upward significantly. North Shore Ex. LTB-1.1, page 1 of 2, shows the monthly NYMEX natural gas prices for the last 13 years. As can be seen, the overall level of prices has been rising and considerable price volatility has been experienced. Indeed, the month-to-month price variances have been much greater during the last several years. North Shore Ex. LTB-1.1, page 2 of 2, shows the history of North Shore's monthly gas charge for the last 13 years. It is not surprising that it reflects the price fluctuations and increases that have occurred in the wholesale markets. The homes being built are better insulated and contain more efficient appliances. The weather normalized average annual use per small residential heating customer has declined from

159 dekatherms to 133 dekatherms over the last ten years, a 16% decrease. North Shore Ex. LTB-1.2 shows the continual decline in the usage of residential heating customers over the past ten years.

While the Company has the ability to directly recover these costs from customers, albeit with no markup, customers react to the higher natural gas prices in part by reducing their consumption. In addition, reduced consumption also occurs as customers replace less efficient gas furnaces and water heaters with more efficient ones. A large part of the Company's cost of providing service is recovered through volumetric charges, so reduced usage per customer directly and adversely impacts the Company's ability to earn a reasonable rate of return on its investment.

Q. How does this decrease in average use affect the Company financially?

A. In the last rate case, the Commission approved rates which provided the Company with non-gas revenue of approximately $32 per residential heating customer per month. In fiscal year 2006, the Company received approximately $26 of non-gas revenue per residential heating customer per month, a 19% decline. This non-gas revenue per customer is used to cover the Company's non-gas operating expenses and costs for borrowed capital, and to provide a return on investment. The reduction in the non-gas revenues per customer is directly attributable to the reduced usage per customer and weather variations.

III. KEY COMPONENTS OF THE COMPANY'S RATE DESIGN PROPOSAL

A. Current Rate Design Challenges

Q. What are the current challenges facing the Company in terms of its ability to earn an adequate return of and on its investment while continuing to provide high quality, safe, adequate, and reliable service to its customers?

A. There are five major challenges: (1) weather trending warmer; (2) reduced consumption per customer; (3) a volatile and high gas price environment; (4) ongoing cost of doing business in an environment of rising costs which affects the Company's operating costs and capital expenditures; and (5) a need to balance the Company's recovery of its mostly fixed costs and the customers' desire for low and stable bills. Each of the challenges negatively impacts the Company's ability to earn its approved margin revenues, i.e. its cost of service exclusive of purchased gas and flow-through items.

Q. What is the Company proposing in this case to answer these challenges?

A. First, with regard to the trend of warmer weather, the Company is proposing to move to a normal degree day measure based on ten years, rather than the thirty years used previously. By setting rates using volumes predicated on a more realistic weather expectation, the Company increases the likelihood of actually recovering its costs through the rates approved in this case. Mr. Marozas addresses the statistical support for the ten-year normal method and Dr. Takle discusses the trend toward warmer weather in their direct testimonies (Marozas Direct and Takle Direct, North Shore Exs. BMM-1.0 and EST-1.0, respectively). This proposal is substantially similar to Nicor Gas Company's proposal for a weather normalization period based on 10 years, which was approved by the Commission in ICC Docket No. 04-0779.

Second, with regard to declining use per customer, customer conservation and energy efficiency efforts should be encouraged, but their impacts should be neutral to the Company. North Shore knows that it is good for customers to use less natural gas. It is a valuable natural resource that, as a societal goal, should be conserved. Also, approximately 75% of the customer's bill is the cost of gas. Reducing consumption is the best way for a customer to contain costs.

While the Company believes that conservation should be encouraged, it cannot continue to absorb the related margin revenue losses. These losses threaten the ability to continue to provide safe, adequate and reliable service to all customers. Therefore, North Shore is proposing Rider VBA, which is a decoupling mechanism designed to maintain the Company's margin despite the reduction in throughput on the system. This proposal is complemented by a proposed conservation program, Rider EEP, that will fund energy efficiency programs. I will summarize the policy aspects of this proposal later in my testimony. The policy aspects of these proposals also are addressed in the direct testimony of Mr. Feingold (Feingold Direct, North Shore Ex. RAF-1.0). Meanwhile, Ms. Grace describes the details of the volume balancing adjustment (Rider VBA) and the rider for enhanced efficiency program (Rider EEP) in her Direct Testimony (Grace Direct, North Shore Ex. VG-1.0). Ms. Rukis describes the processes of the energy efficiency program (Rukis Direct, North Shore Ex. IR-1.0).

Third, North Shore proposes to address the issue of higher gas prices in two ways, namely by encouraging both conservation and competition. The Company currently hedges the prices of much of the gas that it purchases and has storage in its supply portfolio, which helps to mitigate seasonal price differences. While hedging may not, and is not intended to, achieve the lowest price, it does enhance price stability and reduce price volatility. There is very little else that the Company can do in this arena to control gas costs without sacrificing reliability. However, the Company's proposed energy efficiency program will affect the demand side of the supply/demand equation and could cause the balance to be achieved at a lower overall price.

North Shore also believes that customers can benefit from increased competition. Under the Company's current transportation programs, all customers have the choice to purchase their supply from North Shore or a third-party supplier. Currently, all the large volume customers participate in the competitive gas market by buying their gas from a third-party supplier. In contrast, however, a very low percentage of small volume customers take advantage of the opportunity. Small volume customers may benefit from the ability of alternative suppliers to offer them a competitive price. Consequently, North Shore is proposing several changes to its tariffs in this filing to improve this service for both the suppliers and customers, and to encourage the further development of this service for small volume customers. These proposals are discussed in the direct testimony of Mr. Zack (Zack Direct, North Shore Ex. TZ-1.0).

Fourth, Commission approval of the Company's requested revenue increase will allow it the opportunity to recover its costs and to earn a reasonable rate of return. Prospectively, North Shore will have to continue its cost control activities and continue to push for even more efficiencies to maintain operating and capital costs at a reasonable level into the future so that the need for rate relief will be mitigated.

Fifth, in addition to proposing the weather normalization/decoupling mechanism I discussed previously, the Company also is proposing a revised method of recovering the gas cost portion of bad debt. This proposal is contained in Rider UBA, Uncollectible Balancing Adjustment, and is described by Mr. Feingold and Ms. Grace (Feingold Direct and Grace Direct, North Shore Exs. RAF-1.0 and VG-1.0, respectively). In addition, as also detailed in Ms. Grace's testimony, the Company is proposing to move recovery of a larger portion of fixed costs out of variable distribution charges and into monthly customer and demand charges.

B. RATE DESIGN PROPOSALS

1. Basic Rates

Q. What changes is North Shore proposing for its basic charges?

A. North Shore is requesting an increase in charges for all of its service classifications with an emphasis on recovering more of its fixed costs through fixed charges. Consistent with the last rate case, all service classifications are set at cost. North Shore is proposing to split its small residential service classification into space heating and non-space heating services classifications to facilitate setting those rates at cost and recovering a larger share of fixed costs through fixed charges. Mr. Amen discusses North Shore's embedded cost of service study which guided the rate design proposals. (Amen Direct, North Shore Ex. RA-1.0) Ms. Grace provides the details on the rate design proposals including the proposed monthly customer charges and distribution charges. (Grace Direct, North Shore Ex. VG-1.0)

2. Transportation Riders

Q. What changes is the Company proposing for its transportation program?

A. We are proposing to simplify the transportation services while instituting more equitable parameters for service. The program that was initially limited to small volume customers will be expanded to allow all but the largest commercial and industrial customers to take service under this program. The large volume program will be consolidated and the terms of the service revised to match more closely the assets with which the Company supports that program.

3. <u>Rider EEP (Enhanced Efficiency Program)</u>

Q. Please briefly describe the Company's proposal with regard to energy efficiency.

A. The Company is proposing to identify and support conservation programs that will benefit customers. This effort will focus on programs that target residential heating customers, low-income customers and small commercial customers. The costs of the programs will be recovered, through Rider EEP, from the service classifications benefiting from the programs. The proposal is explained more fully in the testimony of Mr. Feingold, Ms. Rukis, and Ms. Grace (Feingold Direct, Rukis Direct, and Grace Direct, North Shore Exs. RAF-1.0, IR-1.0, and VG-1.0, respectively).

Q. Why is the Company making an energy efficiency proposal in this case?

A. First of all, the Company generally supports energy efficiency measures in its service territory. It has provided conservation tips and information to its customers for many years. In addition, annually it engages in a service project to help a number of customers weatherize their homes before winter. However, at this point in time it is important to become more structured in our approach to energy efficiency. Secondly, as part of the merger proceeding, ICC Docket No. 06-0540, the Company agreed to several Conditions of Approval related to energy efficiency. These are conditions 27 through 30 and are contained in my exhibit LTB-1.5. The testimony provided by Ms. Rukis and Ms. Grace describes the energy efficiency program that company is proposing to meet these conditions and the allocation of the $7,500,000 between Peoples Gas and North Shore.

Q. Why is $7,500,000 a reasonable amount to fund energy efficiency in the service territories of Peoples Gas and North Shore?

A. Given Integrys' experience in the operation of energy efficiency programs in other states and our understanding of the need in Illinois due to the lack of recent coordinated efforts in the efficiency sector, in our judgment $7,500,000 is a reasonable level, balancing the rate impact and the need for energy efficiency.

4. <u>Rider VBA (Volume Balancing Adjustment)</u>

Q. Why is North Shore proposing a decoupling mechanism?

A. To date, North Shore has had to absorb the financial impacts of load reductions which, as I have shown, have been significant. Many of the Company's costs of providing service are fixed costs that are not affected by reductions in usage per customer, such as wages and salaries, employee pension and benefits, rents, and depreciation and return on fixed plant such as mains and services. These costs do not vary based on throughput, but are currently recovered largely through volumetric charges. Even under the proposed rate design, a significant amount of fixed costs will continue to be recovered through volumetric charges. The Company needs to decouple its cost recovery from the volumes used by customers, particularly with respect to non-usage sensitive costs of service, if it is to have any chance of earning a reasonable return and thereby maintain its ability to provide safe, adequate, and reliable service to customers in an increasing energy efficient environment. Customers would continue to benefit from the reduced consumption through their savings on their gas charge, which is the much larger piece of the customer's overall bill, while the Company would not continue to see its margin erode over time due to continuing reductions in usage per customer.

Q. What are the risks that the Company and its customers face due to weather?

A. Volumes and prices have the biggest impact on the customers' bills and the Company's financial performance. Variations in volumes from year to year are primarily driven by weather. (Over the longer term, as I have discussed, volumes are declining due to ongoing reductions in usage per customer.) North Shore Ex. LTB-1.3, page 1, shows the monthly degree day variation from normal and page 2 shows the annual degree day variation since 1995. This variation is shown versus the Company's proposed 10 year normal. Though moving to the 10 year normal produces less variation than the 30 year normal, there will still be differences that affect customers' bills and the Company's margin.

Q. Is the Company making any tariff proposals to mitigate the impacts of the volume variation driven by weather?

A. Yes. The Company is proposing weather normalization through the decoupling rider mechanism. Rates are designed based on normal weather, and this mechanism is an adjustment that is derived from the weather assumption underlying the Company's base rates. The weather normalization in the decoupling mechanism will reduce the impact of high bills to customers when the weather is colder than normal (based, as I have indicated, on 10 years rather than 30 years) and reduce the Company's loss of margin when the weather is warmer than normal and bills are lower.

Q. How will North Shore implement the decoupling mechanism and the weather normalization mechanism?

A. The Company proposes to effectuate Rider VBA. This proposal would mesh the weather normalization adjustment with the decoupling adjustment for easier administration, but each adjustment could stand on its own. This adjustment mechanism will help to maintain the Company's margin at the level that results from the order in this docket.

Of course, to earn a reasonable return, the Company will also have to continue to control costs. Rider VBA addresses only the impacts of weather and load loss, which are factors outside the Company's control. Under this proposed rate mechanism, which is discussed in greater detail by Mr. Feingold and Ms. Grace, North Shore will adjust customer bills in order to recognize the margin recovery allowed by the Commission in this rate case (Feingold Direct and Grace Direct, North Shore Exs. RAF-1.0 and VG-1.0, respectively).

Q. What impact would the implementation of the energy efficiency program have on North Shore's need for a decoupling mechanism?

A. The energy efficiency and conservation programs are expected to accelerate load reductions in the Company's service territory. North Shore is making a long term commitment to energy efficiency in its service territory. This should evolve into significant savings for customers but also load loss for the Company.

Q. What are the benefits of the proposed Rider VBA with the energy efficiency program?

A. All customers will benefit because the base rate portion of their bill will not be affected by weather, while the customers who participate in the energy efficiency program will benefit from having lower consumption and, therefore, lower bills. In addition, there are societal benefits – even the customers who do not participate in the energy efficiency program will benefit from the availability of the program. Customers who can conserve on their gas usage or use gas more efficiently will pay a smaller portion of their income for natural gas and, therefore, have more money to save or spend to support the local economy. Further, the dollars spent on conservation and energy efficiency projects in customers' homes and businesses will largely go to local service providers and, therefore, also support local jobs and businesses. In addition, North Shore will benefit because its margin is protected from weather impacts and it will no longer be harmed by customers reducing consumption.

5. Rider UBA (Uncollectible Balancing Adjustment)

Q. What are the effects on North Shore and its customers of increased bad debt expense due to higher gas prices?

A. As gas charge billings are driven up by higher gas prices, increased bad debt expense follows, even though the Company's base revenues do not rise. As prices rise, some customers have an increasingly hard time making their payments, which increases the Company's bad debt percentage. North Shore's bad debt expense is 0.7% of total revenues in the test year. Using a 0.7% bad debt rate, for every $1 per dekatherm change in the cost of gas, bad debt expense changes by approximately $150,000. Since fiscal 1996, the average annual gas charge for the Company has varied from a low of $2.742 per dekatherm to a high of $8.664 per dekatherm. Under North Shore's current rates, all bad debt expense is recovered through base rates, even though a significant portion of bad debt expense is due to the gas charge portion of the bill. The recoverable expense incorporated into the revenue requirement is a function of the Company's bad debt percentage and total test year revenues. To the extent actual revenues vary from the test year, the bad debt expense is effectively either under- or over-recovered by the Company. If prices are stable and match the test year when rates were set, this effect is small. If prices are volatile and vary significantly from the test year when rates were set, however, then there can be a significant mismatch between the recovered expense and the actual expense.

North Shore Ex. LTB-1.4 illustrates North Shore's actual bad debt expense from fiscal years 1995 through 2005. The solid line is the bad debt expense included in the revenue requirement in that case and the dashed line is the base rate piece of that bad debt expense. The base rate piece of bad debt expense is shown in the light grey portion of the bar and the gas cost portion of the expense is shown in the patterned portion of the bar. For the last several years, the total bad debt expense has greatly exceeded the amount allowed in the last rate case, but for several years prior to that, the total bad debt expense was below that allowed. While the base rate portion has been fairly constant over time, and has only changed due to the Company experiencing a higher bad debt percentage rate, the gas cost piece has varied considerably over time due to both the change in the rate and, more significantly, the change in the cost of gas.

Q. How has bad debt previously been treated in rate cases?

A. Typically, it has been treated as an expense to be recovered through base rates. Up until the last few years, this treatment was generally fair to both customers and the utility. More recently, with the increases and volatility in gas prices as shown in North Shore Ex. LTB-1.1, it is not fair to either. In years when the actual gas costs are lower than those used in the rate case filing, the customers actually overpay for bad debt. In years when the actual gas costs are higher than those used in the rate case filing, the Company under-recovers for bad debt. For this reason, North Shore is proposing to recover the gas cost portion of the bad debt expense though Rider UBA rather than through base rates.

Mr. Feingold will describe why the gas cost portion of bad debt should be recovered through a rider (Feingold Direct, North Shore Ex. RAF-1.0). As he points out, a number of other public utility commissions have already adopted this approach. North Shore proposes to retain the base rate portion of bad debt as an expense that is recovered through base rates. This portion does not vary significantly unless the overall bad debt rate changes, and recovering it through base rates is appropriate as an incentive for the Company to keep this rate as low as possible. Ms. Kallas discusses the Company's activities related to controlling bad debt expense (Kallas Direct, North Shore Ex. LK-1.0).

Q. How does North Shore's proposal to recover the gas cost portion of bad debt through Rider UBA affect the requested revenue increase in this proceeding?

A. North Shore calculated that the gas cost related portion of uncollectibles for the fiscal 2006 test year was $1,542,000. If the Company is allowed to recover these costs through Rider UBA, its base rate increase is reduced to $4,772,000, as I indicated earlier. Mr. Fiorella discusses Rider UBA and how it affects the requested revenue increase (Fiorella Direct, North Shore Ex. SF-1.0).

IV. GAS CHARGE SETTLEMENT

Q. In March 2006, North Shore settled numerous gas charge reconciliation cases by agreeing, among other things, to provide credits to customers totaling $4 million and committing to fund conservation programs through 2011. What effect, if any, does this settlement have on North Shore's requested revenue increase presented in this filing?

A. The settlement and the payments North Shore has made or committed to make pursuant to the settlement have no effect on the amount of the requested revenue increase. The settlement related to the gas costs billed to customers through the gas charge for fiscal years 2001 through 2004; whereas, this filing pertains to the level of the Company's delivery rates through which it will recover its costs of delivering gas to its customers after the expected 2008 order date in this docket. North Shore reflected the settlement refunds and the $200,000 payment for conservation in its fiscal 2006 historical data provided in this filing. However, Mr. Fiorella eliminates these expenses from the proposed test year revenue requirement through his rate making adjustment shown on Schedule C-2.11 of North Shore Ex. SF-1.1. As explained by Mr. Johnson, the settlement had no effect on the test year capital structure, because the Company eliminated dividends to its parent company for two quarters in order to restore North Shore's common equity balance to the level it would have been but for the settlement-related charges to retained earnings (Johnson Direct, North Shore Ex. BAJ-1.0).

Q. Does any part of this rate increase request reimburse the Company for some or all of the monies that were credited to customers pursuant to the order in the reconciliation cases?

A. No.

V. <u>MERGER CONDITIONS</u>

Q. As part of the order in ICC Docket No. 06-0540, the Company accepted certain Conditions of Approval. Do any of these conditions affect this filing?

A. Yes, certain of the Conditions of Approval do affect the presentation and the substance of the Company's rate increase request. North Shore Ex. LTB-1.5 is a listing of the specific conditions that affect this filing. In total there are 18 conditions which were considered.

Q. Please describe these conditions and provide information on how they are dealt with in this filing.

A. I will discuss Conditions 1, 2, and 9. Mr. Fiorella discusses Conditions 13, 15, 16, and 21. Mr. Doerk will discuss Conditions 22 and 24. Ms. Grace will support the Company's proposal for cost recovery of the energy efficiency program discussed in Condition 27 b) and the Company's proposal for cost recovery of the gas cost portion of bad debt discussed in Condition 35 c). Ms. Rukis will discuss Conditions 28, 29 and 30 and the portion of Condition 27 not covered by Ms. Grace. Mr. Zack will discuss Conditions 34 and 36 and the portion of Condition 35 not covered by Ms. Grace.

Q. Please describe how the Company has met Conditions of Approval 1, 2, and 9.

A. Condition 1 relates to the tax impact of the last-in-first-out ("LIFO") gas in storage issue. The Company committed that it would not propose to recover any taxes that resulted from this issue in any future revenue requirement. Because the merger closed in February 2007, the historical test year does not contain any effect of this issue and no ratemaking adjustment is proposed for this issue.

In Condition 2 the Company committed that the application of purchase accounting for financial reporting purposes would be disregarded for ratemaking purposes. Because the merger closed in February 2007, the historical test year does not contain any effect of purchase accounting and no ratemaking adjustment is proposed regarding purchase accounting.

In Condition 9 the Company committed that it would file certain annual reports on the same day it files this rate case. This filing was made.

Q. Does this conclude your direct testimony?

A. Yes.