STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

THE PEOPLES GAS LIGHT AND COKE COMPANY	:	
	:	No. 07-____
Proposed General Increase In Rates For Gas Service	:	

Direct Testimony of

JAMES F. SCHOTT, CPA

Vice President – Regulatory Affairs,
Integrys Energy Group, Inc., and The Peoples Gas Light and Coke Company

On Behalf of
The Peoples Gas Light and Coke Company

March 9, 2007

Q. Please state your name and business address.

A. My name is James F. Schott. My business address is The Peoples Gas Light and Coke Company ("Peoples Gas"), 130 E. Randolph Drive, Chicago, Illinois 60601.

Q. Mr. Schott, by whom are you employed and in what capacity?

A. I am the Vice President – Regulatory Affairs of the Integrys Energy Group, Inc. ("Integrys"), as well as for Peoples Gas.

Q. On whose behalf are you offering this testimony?

A. I am offering this testimony on behalf of Peoples Gas.

Q. What is the purpose of your direct testimony?

A. The purpose of my direct testimony is to address the rationale for Peoples Gas' proposed Rider ICR - Infrastructure Cost Recovery ("Rider ICR"). Proposed Rider ICR is a mechanism that would allow recovery of costs associated with shortening the projected replacement time and reducing overall cost for the replacement of the cast iron and ductile iron ("CI/DI") mains in the Peoples Gas distribution system.

Q. What conclusions have you reached in your direct testimony?

A. I have concluded that acceleration of Peoples Gas' ongoing CI/DI replacement program by means of implementing Proposed Rider ICR has a number of benefits for customers, the City of Chicago, and Peoples Gas and that Rider ICR is the appropriate rate mechanism to achieve program benefits.

Q. Mr. Schott, please describe your education and business experience.

A. I am a 1979 graduate of Georgetown University with a Bachelor of Science in Business Administration. I received a Masters in Business Administration from the University of Wisconsin – Milwaukee in 1993. I was employed by Arthur Andersen & Co. from 1979 to 1990, specializing in public utility taxation and ratemaking. From 1990 through 2002, I was employed by Wisconsin Gas Company in various finance and operating responsibilities. From l998 to 2002, I was Senior Vice President of Wisconsin Gas Company with responsibility for all utility operations. I was also responsible for the gas operations of Wisconsin Electric Power Company, an affiliate of Wisconsin Gas Company from 2000 to 2002. I have served as Vice President - Regulatory Affairs of Wisconsin Public Service Company ("WPSC") since January 2003. Upon the formation of Integrys Energy Group, Inc., I became Vice President - Regulatory Affairs of Integrys and Vice President - Regulatory Affairs of Peoples Gas. I am a licensed Certified Public Accountant in the State of Wisconsin.

Q. Please describe your current duties and responsibilities.

A. My responsibilities include all regulatory and rate matters for all jurisdictions for the regulated businesses of Integrys. I also serve on the board of directors of Integrys' regulated natural gas subsidiaries, Peoples Gas, North Shore Gas Company, Michigan Gas Utilities Corporation and Minnesota Energy Resources Corporation.

Q. Please describe Peoples Gas' existing CI/DI replacement program ("Existing Replacement Program").

A. Currently, Peoples Gas' system is comprised of nearly 2,000 miles of CI/DI mains. This amount represents a considerable portion of the overall Peoples Gas system mains, approximately 49%. For many years, Peoples Gas has been engaged in an undertaking to systematically replace the CI/DI mains with more modern cathodically protected steel or plastic pipe. Indeed, in 1981, there was 3,450 miles of CI/DI mains on the system. Over the ensuing 25 year period, Peoples Gas reduced the amount of CI/DI pipe by nearly 1,500 miles, utilizing criteria that are designed to eliminate serious cracks and leak incidents and take advantage of optimization opportunities associated with the main segment. Peoples Gas witness Mr. Doerk (Peoples Gas Ex. ED-1.0) will describe the Existing Replacement Program and the replacement criteria in more detail in his direct testimony.

Q. How does proposed Rider ICR pertain to the Existing Replacement Program?

A. The Existing Replacement Program would be unaffected by proposed Rider ICR. Proposed Rider ICR will give rate effect to Peoples Gas' proposal to accelerate the replacement of CI/DI mains. In effect, the accelerated CI/DI main replacement program ("Accelerated Program") is an incremental complement to the Existing Replacement Program.

Q. Please describe proposed Rider ICR.

A. The details concerning the mechanics of Rider ICR are discussed by Peoples Gas witness Ms. Grace (Peoples Gas Ex. VG-1.0) in her direct testimony. Generally, as Ms. Grace describes in more detail, the Rider would compute an annual adjustment that will be billed on a monthly basis to reflect the incremental

capital-related costs associated with Peoples Gas' Accelerated Program. The amount recoverable under this Rider will be a function of any differences between the average of the "baseline" levels of capital expenditures of the Existing Replacement Program during fiscal years 2004, 2005 and 2006, which fiscal years were the twelve month periods ended September 30, and the actual capital expenditures.

Q. How will the proposed Rider ICR address the business challenges faced by Peoples Gas?

A. Proposed Rider ICR will provide Peoples Gas with a current basis to recover the recurring capital related costs associated with its proposed Accelerated Program. From a strict ratemaking perspective, Rider ICR will enable Peoples Gas to take advantage of more opportunities to replace portions of its gas system without the negative financial consequences such business actions would create under traditional ratemaking methods. Absent Rider ICR, if Peoples Gas were provided with opportunities to accelerate its Existing Replacement Program, the additional costs of replacement would only be recoverable in base rates after the completion of Peoples Gas' next rate case. Even then, return of and on capital between rates cases would be forgone.

Q. What benefits would be conferred upon the system by the implementation of Rider ICR?

A. Rider ICR would give Peoples Gas greater flexibility in its ongoing activity involving the replacement of CI/DI mains. The Rider would allow Peoples Gas to replace larger amounts of CI/DI mains on its system in a considerably shorter

time frame than the 40 to 45 year time frame presently in place. Furthermore, Rider ICR would enable Peoples Gas to avail itself of unforeseen opportunities to replace CI/DI mains in a more efficient manner, and provide Peoples Gas with the ability to recover its costs of program implementation in a fair and equitable manner.

Q. Has Peoples Gas conducted an evaluation of its Existing Replacement Program?

A. Yes. Peoples Gas commissioned Kiefner and Associates, Inc., to perform a study ("Study") of its Existing Replacement Program and to assess the feasibility of its continuation. The Study affirms that the Existing Replacement Program has been conducted in a prudent and reasonable manner and reflects an analysis that validates that the time horizon and replacement criteria incorporated in the Existing Replacement Program continues to support a reasonable, measured and safe approach to CI/DI replacement. The Study also fulfills the Company's obligations under the first paragraph of Condition No. 23 of the Conditions of Approval contained in Appendix A to the Illinois Commerce Commission's ("Commission") Order in Docket No. 06-0540 approving Peoples Gas' participation in a reorganization. The relevant section of Condition No. 23, which is set forth in Peoples Gas witness Mr. Borgard's Peoples Gas Ex. LTB-1.6, requires that the Study be completed by March 1, 2007 and be provided to the Commission's Director of the Energy Division. The Study has been so provided.

Q. What are some of those other considerations that could be taken into account in determining the optimum approach for replacing the CI/DI mains assuming financial ability and sufficient cost recovery?

A. The ability to accelerate the time frame in which the Existing Replacement Program is operating could result in considerable benefits to the system, including certain financial benefits. In addition, accelerating the Existing Replacement Program would have the salutary effect of modernizing and strengthening an important component of the overall infrastructure of the City of Chicago.

Q. In addition to the benefit of improving and modernizing the overall infrastructure of the City of Chicago, please discuss what other benefits the Accelerated Program would provide to customers.

A. The Accelerated Program will provide several other benefits. These include: (1) Financial benefits associated with expending current dollars for a major monetary undertaking; (2) Benefits relating to the replacement of Peoples Gas' low pressure system; and (3) Benefits afforded by the opportunity to respond to the dynamic development in the City of Chicago.

Q. What are the financial benefits that would accrue from accelerating the Existing Replacement Program?

A. The Existing Replacement Program and the Study reflect an analysis that incorporates an estimate of the Existing Replacement Program in real dollars over the life of the Existing Replacement Program. The analysis simply takes the average current cost of replacing a certain length of main and multiplies it times the length of main to be replaced. Such an analysis assumes a static approach to the Existing Replacement Program. The Accelerated Program, which offers a different time frame and incorporates different timing assumptions than those

inherent in the Existing Replacement Program, would generate different cost and financial results.

Q. Please explain how different financial and cost results would flow from the Accelerated Program.

A. First, the Existing Replacement Program currently is based on current cost. By taking a long term view of the program and by investing more money up front, as will occur under the Accelerated Program, the total long term cost of the project can be reduced. This reduction would theoretically occur in several ways. One way in which cost savings could be achieved is if it is assumed that the accelerated replacement of CI/DI in today's dollars would be cheaper than if the work were performed in the outer years of the 40 to 45 year time frame on which the Existing Replacement Program is predicated. In addition, savings would occur by accelerating main replacement and avoiding the cost of maintenance incident to leaks that would otherwise occur absent acceleration. Cost savings could also be expected to be achieved in the street repair costs associated with main repair and replacement.

Second, there are cost savings that can be achieved by replacing certain portions of the Peoples Gas system in a manner that is not currently recognized in or anticipated in the Existing Replacement Program. Specifically, the benefits of reducing or eliminating a low pressure system have not been factored into the analysis of the feasibility of the Existing Replacement Program. Much of the CI/DI mains and virtually all of the small diameter pipe that the Study states is the most critical to replace are part of a low pressure system.

Q. Please describe the low pressure system.

A. It is important to understand how the Peoples Gas system developed and evolved. The original gas distribution system for Chicago was designed for street lights and some residential and commercial lighting. Eventually, the distribution system evolved to provide gas for cooking. A low pressure system was adequate and properly designed for such purposes. Beginning in the 1930s, natural gas became economic to use for space and water heating and soon replaced manufactured gas. As a result, the flow of gas on the system began to increase dramatically. The continued growth in the system as the City of Chicago expanded also put a strain on the system. Finally, the expansion of the use of natural gas further complicated matters by changing the source of the gas into the system from the relatively small volume manufactured gas plants to the high volume interstate natural gas pipelines. To address these changes, Peoples Gas expanded the medium and high pressure system. However, the low pressure system has continued at the same pressure it has always been since Peoples Gas was founded in 1855.

Q. What are the benefits of replacing the low pressure system?

A. As Mr. Doerk states, the low pressure system requires numerous regulator stations located throughout the gas distribution piping system. Eliminating the low pressure system would enable Peoples Gas to eliminate an entire class of these regulator stations over time. Furthermore, most of the meters on the low pressure system are located inside buildings, requiring federally mandated safety inspections of the Company's facilities inside the building. Scheduling these

inside inspections can be an inconvenience for customers, especially for residential customers in situations where no one is normally home during the day. When changing the distribution system from a low pressure system to a medium pressure system, small regulators can be added outside the building and the meter can be moved outside as well, as Mr. Doerk notes. Hence, several benefits are obtained, including eliminating the difficulties attending arranging customer calls and the need for future inside inspections. The relocation of meters would also assist in the installation of automatic meter reading devices and would make it easier to detect meter tampering.

Q. Is there any other benefit from replacing a low pressure system?

A. Yes. Another of the problems with low pressure systems is the occurrence of groundwater infiltration which can lead to service outages. Mr. Doerk explains when ground water collects in gas mains, the flow of gas is restricted, in many cases causing service outages. High pressure gas replacement systems eliminate this problem because water cannot physically infiltrate high pressure systems. As Mr. Doerk testifies, high pressure distribution systems are inherently more reliable and cost effective than older vintage low pressure systems.

Q. Please discuss how savings would be obtained by a more methodical and faster process of replacing the CI/DI mains.

A. As noted above, the approach ("Current Cost Approach") Peoples Gas has taken in the past, which the Study affirms and that is appropriate from a safety standpoint, is to maintain the schedule to replace the CI/DI mains on a current cost basis. Adherence to the Current Cost Approach, however, as the Study

points out, will require an expenditure of over $1 billion in current year dollars over the next 40 to 45 years to fully replace Peoples Gas' CI/DI main. While the Current Cost Approach may indeed provide the least current year cost, when $1 billion dollars is to be spent, there are considerably greater economies of scale available in a more accelerated program than would be obtained under the current incremental approach.

Q. Please explain the greater economies of scale that are available in a more accelerated CI/DI mains replacement program.

A. For example, the main ranking index as discussed in Mr. Doerk's testimony may indicate that a section of main should be replaced. Peoples Gas would apply a financial optimization methodology to determine whether adjacent and nearby sections of main should be replaced as well. Within its limits, this approach keeps the system safe at the current cost. If, however, that section of main that is being replaced will be replaced as a low pressure main because a medium pressure system is not available in that vicinity to upgrade it, additional work will be required when it eventually is upgraded to a medium pressure main. If Peoples Gas had the flexibility to perform a full system upgrade, the additional work and attendant cost could be avoided.

Q. To what extent, if any, would the Accelerated Program affect Peoples Gas' ability to coordinate with the City of Chicago and other parties?

A. Peoples Gas has historically coordinated main replacement with the City of Chicago during its normal rebuilding or replacement of roads in Chicago. When streets are torn up for rebuilding, Peoples Gas has had an opportunity to replace

those sections of mains involved. Special projects undertaken by the City and projects and events that arise from third parties other than the City can be unpredictable and unforeseen. Such projects can provide even greater opportunities for better coordination to achieve significant cost savings and expedite CI/DI replacement.

Q. Please elaborate.

A. The City of Chicago is one of the most dynamic cities in the U.S. in respect of development and change. Often development occurs in an unpredictable fashion and in surprising ways that present opportunities for main replacement. If Peoples Gas had a mechanism which would be financially sound, such as the proposed Rider ICR, it would be able to take advantage of these opportunities for the benefit of customers, the City and the utility. A recent chain of events demonstrates this dynamic. The City of Chicago developed plans for the expansion of the McCormick Place complex by adding McCormick Place West. This construction activity presented a wealth of opportunity to replace or upgrade mains.

Q. Can you offer any other examples of unexpected opportunities that may arise?

A. An opportunity could be presented should the City's bid to host the Olympic Games be successful. If the decision is favorable to the City of Chicago, the decision will be swift and will generate activity for unprecedented development all around the City. Already plans such as Olympic venues and significant public transportation projects are under discussion. A similar opportunity could be presented should the proposed Crosstown Expressway be constructed. To be able

to work in conjunction with these massive development efforts across the City would provide Peoples Gas the opportunity to expedite main replacement and take advantage of joint construction efforts which would reduce the cost that Peoples Gas would otherwise pay for the replacement of the mains.

Q. Could Peoples Gas achieve these cost reductions and expedited benefits under its Existing Replacement Program?

A. No, the opportunities presented by events such as the ones I have discussed above cannot be known in advance and therefore cannot be budgeted. Simply put, the Existing Replacement Program, which involves a static amount for main replacement, would not be sufficient to address a more dynamic and accelerated main replacement approach.

Q. What is Peoples Gas proposing at this time?

A. Peoples Gas is proposing an additional program to complement the Existing Replacement Program. Peoples Gas is seeking authorization to implement the Accelerated Program, along with the Existing Replacement Program.

Q. Do the base rates proposed by Peoples Gas in this proceeding give Peoples Gas the opportunity to recover the costs of the proposed Accelerated Program?

A. No, they do not. Only the cost of the Existing Replacement Program through fiscal year 2007 is included in the base rates.

Q. In your opinion, from a ratemaking perspective, why is rider treatment the appropriate rate recovery mechanism for the Accelerated Program?

A. The proposed Accelerated Program would be among the most ambitious and comprehensive that Peoples Gas has undertaken since the maturation of its system decades ago. The Accelerated Program will involve a considerable amount of planning and adjusting plans to address conditions that may be discovered or that may ensue as the result of unpredictable events. Therefore, the Accelerated Program and the costs associated with it will entail much more than the historical, normal construction and infrastructure upgrade activity of Peoples Gas. Moreover, the magnitude of the costs are too great to expose Peoples Gas to the financial risks that attend the normal regulatory recovery process involving rate case proceedings and the peculiarities of timing which that process involves. Only a rider, such as Rider ICR, would adequately address the issue of managing costs of the magnitude anticipated on an ongoing basis and allowing Peoples Gas the nimbleness to respond to external forces and events and thereby manage the unpredictability and uniqueness of the opportunities that lead to the Accelerated Program costs. In a city with the recent history of dynamic growth like Chicago, predicting when and how much money will be spent for infrastructure improvement is difficult.

Q. Does this conclude your direct testimony?

A. Yes.