STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	)	
	)	
Proposed General Increase	)	No. 07-0241
In Rates for Natural Gas Service	)	
	)	
	)	
THE PEOPLES GAS LIGHT AND	)	
COKE COMPANY	)	
	)	
Proposed General Increase	)	No. 07-0242
In Rates for Natural Gas Service	)	

JOINT REPLY BRIEF OF THE CITY OF CHICAGO AND THE CITIZENS UTILITY BOARD

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Dated: October 12, 2007

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[1] "PGL" = Peoples Gas. "NS" = "North Shore". Use of these acronyms in a parenthetical means the issue relates only to the referenced utility.

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JOINT REPLY BRIEF OF THE CITY OF CHICAGO
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Pursuant to Section 200.800 of the Rules of Practice[2] of the Illinois Commerce Commission ("Commission" or "ICC") and the briefing schedule set by the Administrative Law Judges ("ALJ") in their May 9, 2007 case management order, the CITY OF CHICAGO ("City") by its attorney, Mara S. Georges, Corporation Counsel, and the CITIZENS UTILITY BOARD ("CUB") (collectively "City-CUB") submit their Joint Reply Brief in this proceeding. Our Reply Brief responds to Initial Briefs submitted by The Peoples Gas Light and Coke Company ("Peoples Gas" or "PGL") and North Shore Gas Company ("North Shore" or "NS") (collectively, Peoples Gas and North Shore are referred to as "PGL-NS" or the "Companies") and the Commission Staff ("Staff"). The sections of this brief are organized in accordance with the outline of issues submitted to the Administrative Law Judges ("ALJ") on September 21, 2007.

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2 83 Ill. Adm. Code Part 200.

I. INTRODUCTION

A. Summary

***Pro Forma* Reserve for Accumulated Depreciation**. The Reserve for Accumulated Depreciation is the major offset to Plant in Service in determining Net Plant – the rate base used in setting rates. However, the Companies' and Staff's proposed depreciation adjustment reflects only a portion of the known and measurable change in test year accumulated depreciation that is certain to occur over the period the Companies' *pro forma* plant additions will take place.

In their Initial Brief, City-CUB detailed the Companies' strained misreading of the Commission's *pro forma* adjustment rule and Commission precedent that undergird their position on this issue. The Commission decisions construing its *pro forma* adjustments rule infuse the rule with a substantive policy of assuring that *pro forma* costs and revenues are more reflective of the period rates will be in effect than unadjusted test year data. All parties agree that under the Commission's decisions the facts of each case must control. The facts of record in this case are crucial, if not decisive. Illinois courts have given a stricter meaning to the constraints of the Commission's test year rules and require consideration of costs in the aggregate, not selectively. The Companies' proposal for additions to rate base without offsets is inconsistent with the Commission's own rule for exceptions to its test year rules and distorts the balance of costs and revenues that the test year rules enforce.

OPEB Liabilities and Pension Asset/Liability. In their Initial Brief, the Companies attempt to portray their routine pension plan activity as similar to the unusual action Commonwealth Edison Company ("ComEd") took to correct a significant under-funding of its pensions. However, the Companies' testimony does not present any evidence of special circumstances that warrant a deviation from the Commission's established policy on pension costs – either as to the treatment of the utilities' OPEB liabilities or the Companies' exceptional proposal to include the net pension asset in rate base.

Incentive Compensation Expenses. The testimony offered in support of the Companies' proposal to recover their incentive compensation costs is riddled with uncured deficiencies that preclude recovery under Commission precedent. The Companies' effort to mitigate those deficiencies consisted of a series of incremental reductions in the costs they seek. Now, recognizing the overbreadth of their original request to include all their incentive compensation costs among allowed test year expenses, the Companies emphasize their "Plan B" – recognition of expenses that are nominally related to some aspect of service to customers. However, the evidence of record regarding any such relationship does not show the quantified, tangible benefit to ratepayers required for recovery of those costs. In their brief, the Companies offer a bare list of decisions allowing incentive compensation costs that adds neither legal analysis nor citations to evidence demonstrating compliance with the Commission's evidentiary requirements. The Companies cannot unilaterally redefine the Commission's requirements, and the evidence the Companies present does not meet those standards. The incentive compensation costs should not be allowed.

Invested Capital Taxes. Staff accepts the Companies' *pro forma* test year capital structure as evidence of an otherwise unstated dividend policy – one the Companies *assume* for the future. However, the Companies have not provided any firm evidentiary basis for the Companies' and Staff's assumption that the *pro forma* capital structure used in this case will be in place when Invested Capital Taxes are computed using the Companies' actual retained earnings and total capitalization amounts. Such assumptions do not constitute evidence. Despite multiple opportunities for numerous witnesses, the Companies never offered a single statement that establish a dividend policy that would establish the Invested Capital Taxes amounts computed using the assumed capital structure a "known and measurable" quantity under the Commission's rules for *pro forma* adjustments.

Cost of Common Equity. The reviews of the return on equity ("ROE") analyses in the Initial Briefs of Staff and the Companies focus mainly on technical elements of the various analyses. Staff's review of Mr. Moul's ROE analyses, however, criticized only two of the many adjustments he made to the fundamental model methodologies he employed – his flotation and leverage adjustments. Staff ignored other inappropriate adjustments embedded in Mr. Moul's models, likely because they are improper adjustments that Staff witness Ms. Kight-Garlisch made in her analyses.

As City-CUB explained in our Initial Brief, the source of the variance among the estimates of the experts in this case stem from distinctive views on the appropriate weight that should be afforded CAPM estimates relative to the more objective DCF estimates, and to the appropriate implementation of flawed CAPM theory. Staff and the Companies both dispute that the DCF model merits greater weight than the admittedly flawed CAPM. It is likely not coincidental that the high ROE recommendations of each depend on averaging DCF estimates with much higher, more subjective CAPM estimates.

The DCF model relies heavily on objective market factors, making it most objective and less susceptible to manipulation. It is that characteristic (undisputed on this record), coupled with the serious theoretical and practical problems inherent in the CAPM, that make the DCF estimates more useful to the Commission. One deficiency of the CAPM that is especially relevant in this case is the model's deliberate exclusion of non-systematic risk factors from its ROE estimation. The ROE recommendations of both Staff and the Companies cannot stand without averaging in their CAPM estimates. Yet, in their expressed opinions respecting a central issue in this case – the proposed riders – Mr. Moul and Ms. Kight-Garlisch each reject the fundamental premise of the CAPM analysis that risks peculiar to a utility do not affect its required ROE (because it can be diversified away). The Companies claim that the proposed riders will have no effect on determination of investors' required return. The Companies provide no citations to objective or quantitative evidence of record to support that assertion. On the other hand, there is considerable evidence that the riders would have a significant effect on the magnitude and stability of the Companies' revenues, and that investors would notice, lowering the market required ROE. The effect of only one of the riders (the volume balancing adjustment rider, Rider VBA) in a single year would have been more than $30 million in additional revenue. That single fact conclusively rebuts the Companies' new argument – that the riders are "risk neutral" because they "protect shareholders and customers alike." They are not – at least not from customers' perspective. The Companies' arguments respecting the magnitude of the ROE effect of the riders do not alter the fact that Mr. Thomas's insurance policy proxy analysis is the only quantification of the reduction in the required ROE stemming from approval of the proposed riders, is a conservative estimate of the ROE effect, and is not persuasively rebutted by the Companies' arguments.

On other technical issues:

» Mr. Thomas has presented evidence demonstrating that an upward quarterly dividend adjustment is unnecessary, and expressly asks that the Commission re-examine its use of that adjustment, which unnecessarily increases costs to ratepayers. Staff's working capital arguments completely miss the point of his testimony;

» The Companies recommend a leverage adjustment to maintain their current market-to-book ratios. The Companies have not shown that any of the theoretical causes of a market-to-book excess have any relevance in this case. The record, however, does show that the Companies have experienced significant earnings in excess of authorized ROE and is a likely contributor to their market-to-book ratio. Perpetuating returns above those required by the market is neither a prudent action nor a reasonable cost. Staff's Initial Brief illustrates the deadly – to ratepayers – spiral of increasing ROE awards that would ensue from adoption of the leverage adjustment that Mr. Moul proposes.

» Objective vs. Subjective ROE Estimates – The Commission's acknowledgment that ROE analyses require "the analyst's informed judgment" does not, as the Companies appear to argue, validate all possible sources of informed judgment for purposes divorced from selecting inputs to financial models. This is a surprising expansion of the Companies' previous over-use of subjective bases for ROE determinations.

» Flotation Costs – Ms. Kight-Garlisch joins Mr. Thomas in recommending rejection of Mr. Moul's proposed flotation adjustment. The clear standards established by Commission precedent on this issue and the Companies' failure to meet those requirements require that that adjustment be rejected. The Companies seek impermissible recovery of flotation costs that, on the evidence, are not (a) certain to be incurred or (b) already incurred but unrecovered.

Weather Normalization. In its Initial Brief, Staff expresses neither support for nor opposition to the Companies' proposal to change the Commission's historical normalization practice. The Companies argue that their statistician Mr. Marozas showed that his proposed ten-year HDD average is a superior predictor of weather and should replace the Commission's traditional normalization process. However, Mr. Marozas's testimony leaves considerable doubt that his statistical constructs actually simulate the decision the Commission must make. The spasmodic nature of climate change does not support the Companies' implicit assumption that Illinois climate norms will move uni-directionally (not repeating weather experiences of less than a dozen years ago). Nor does the record support their conclusion that relevant weather data does not include experiences beyond a date arbitrarily determined to be ten years in the past (when ten years was not even Mr. Marozas's best predictor). And, the Commission's decision will be in effect continuously, for an indefinite period, not briefly and one year at a time.

The evidence of record is inadequate to support the proposed drastic change in the Commission's normalization practice. City-CUB continue to recommend rejection of the Companies' proposal or initiation of a more complete review of its merits, flaws and impacts.

Hub Services. The Initial Briefs of Staff and the Companies debate the identity and magnitude of the costs and revenues that should be attributed to PGL's Hub services. Their objective is to persuade the Commission that Hub services should either be the source of an adjustment to PGL's revenue requirement or be discontinued altogether. However, nothing in the Initial Briefs of Staff and the Companies diminishes the advisability of pursuing the course recommended in the Initial Brief of City-CUB. The Commission should preserve its options respecting the use or disposition of Manlove capacity pending the conduct of a proper study using the PGL dispatch planning program. Only in that manner can the Commission assure that PGL's rate bases assets, Manlove storage field in particular, are employed in the most economical and prudent manner for the benefit of PGL ratepayers.

Proposed Riders. The most unusual aspect of the Companies' case is their request that the Commission approve a plethora of new riders that are designed to either (1) recover particular costs in isolation or (2) to protect utility revenues and earnings. Both utilities asked the

Commission to approve Rider VBA, an uncollectibles adjustment rider ("Rider UBA") and an enhanced efficiency program rider ("Rider EEP"). In their rebuttal case, the Companies proposed a weather normalization adjustment ("Rider WNA") as an alternative to Rider VBA. In addition, Peoples Gas asked the Commission to endorse its proposed infrastructure cost recovery rider ("Rider ICR").[3]

In their respective initial briefs, City-CUB, Staff and the Illinois Attorney General (the "AG") demonstrated that the riders are beset with problems. The Companies' Initial Brief did nothing to resolve these problems. The costs that would be recovered through these riders – or the revenues or earnings that would be protected – are not volatile, fluctuating or beyond the utilities' control. As such, the costs – and revenues and earnings – fail to meet criteria established by the Commission and Illinois courts that an expense must meet before it is deemed appropriate for rider recovery. Because the costs – and revenues and earnings – fail to meet these criteria, approving the riders would violate the rule against single-issue ratemaking.

In addition, two of the riders – Rider VBA and Rider WNA – are not designed to recover costs, but would protect utility revenues and earnings. Historically, riders were designed to collect specific cost items. Riders VBA and WNA are significantly different than other riders in that they would protect utility revenues and earnings to either increase or decrease depending on how much gas customers use. Post-decision adjustment of utility revenues would violate the prohibition against retroactive ratemaking.

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[3] The City and CUB agree that Rider VBA, its proposed alternative, Rider WNA, Rider UBA and Rider EEP should be rejected. The City and CUB disagree with respect to Rider ICR. We each filed separate Initial Briefs on this issue. The City and CUB are also filing separate Reply Briefs regarding Rider ICR. Any generic references in this Reply Brief to the Companies' proposed riders are meant to refer only to Rider VBA, Rider WNA, Rider UBA and Rider EEP.

Besides these legal flaws, the evidence shows that two of the riders – Riders VBA and UBA – would likely result in additional revenues for the Companies at the expense of their customers. Backcasts performed by the Companies showed that had these two riders been in effect for the past five years, Peoples Gas would have realized almost $240 million in additional pre-tax operating income and North Shore would have recovered an additional $25 million in pre-tax operating income.

Finally, the evidence and the briefs in this case show that the Companies oversold their proposed riders. The Companies claim that existing business risks are such that the utilities will be threatened with financial peril if the proposed riders are not approved. It is difficult to take this claim seriously from utilities that last filed rate cases in 1995 – more than 12 years ago. Many of the business risks identified by Peoples Gas and North Shore have existed for years and yet the utilities have managed to survive without seeking rate relief.

Cost of Service. In their Initial Brief, the Companies contend that Staff and City-CUB have not adequately explained why the Commission should adopt the A&P method. This contention is entirely without merit. First, the claim rests on a reversal of the statutory burden of proof, which rests entirely on the utilities. The Companies have not shown that the CP allocation method reflects actual cost causation on their system. Although they continue to insist that demand-related costs are incurred entirely to meet peak demands, that assertion was contradicted by the Companies' Vice-President for Gas Operations. He explained that the Companies' system capacity design decisions are actually based on both the demands of customers at the system peak and the load supplied to customers over periods. The Companies' Initial Brief does not explain why that testimony does not preclude adoption of the CP method. The false suggestion that the

A&P method is as extreme as the CP method, in assuming that the distribution system was built entirely to meet average demand, does not aid the Companies' cause. The Companies know that the A&P method takes into account both average and peak demand in allocating distribution-related costs. Indeed, Staff showed that the most significant factor in A&P is peak demand because it represents approximately 3/4 of the allocation. The alleged "significant difference" in the cost of serving S.C. 1 heating and non-heating customers that is the purported basis for the Companies' bifurcation proposal has not been shown to the be the most significant cost driver. Their embedded cost of service study ("ECOSS") does not answer that question, but the Companies' position is again called into question by the operational realities of its system. On the Companies' systems, according to their own distribution expert, a residential customer could double consumption without requiring a larger service pipe. It is not credible that, with the major cost of the service pipe the same for heating and non-heating residential customers, the heating/non-heating distinction is the main cost driver. In the face of specific challenges to their cost of service methodology and results, the Companies have failed to carry their burden to demonstrate that a heating/non-heating distinction rather than the single/multiple family factor City, CUB and AG witness (collectively, "GCI") witness William Glahn identified is the appropriate driver of any class separation proposal. The utilities' Initial Brief does not cure these gaps in evidence, explanation, and understanding respecting their bifurcation proposal.

Rate Design. The Companies have not provided any persuasive argument that justifies its refusal to assign directly to individual customers the customer-specific, highly specialized, and unique costs recorded in Account 385. In less obvious cases of cost responsibility the Companies insist on directly assigning costs to the cost causers.

Using the traditional utility argument of last resort, the Companies' accuse other parties fo failing to disprove its assumption that the risk that the Companies will not recover the costs of service does not vary by customer class. That assumption pervades every allocation among classes in the ECOSS. Clearly, the ECOSS is not an infallible, purely objective basis for apportioning revenues among the customer classes. The Commission must accordingly give increased importance to the impact of thee rate design objective identified in City-CUB testimony. The Companies' list of rate design objectives omits several important objectives that capture public policy concerns that the Companies omitted .

Even after the additional opportunity presented by the initial briefs, the Companies have not articulated a sound basis for their (apparently arbitrary) grouping of service classifications in apportioning its requested increase among customer classes. The arbitrary grouping exacerbates the inequity of the allocation of burdens. For example, there is the complete exemption of S.C. 7 from bearing any of the revenue increase burden.

Similarly, the Companies rely on their fatally flawed proposal to bifurcate S.C. 1 as a basis for establishing proposed monthly customer charges. The Commission should deny Peoples Gas's request to the resulting distorted customer charges that would harm its low- and fixed-income customers and, at the same time, send improper price signals to residential customers. Nothing in the utilities' Initial Brief persuades otherwise.

Because the Companies have failed to provide any cost basis for their proposal, the Commission should reject the proposal to increase the charge for checks or electronic withdrawals that could be processed.

II. RATE BASE

D. Reserve for Accumulated Depreciation and Amortization

In its Initial Brief, Staff notes its acceptance of the Companies' post-test year adjustments to net plant through September 2007, as adjusted by Mr. Kahle to match evidence of actual expenditures. Staff Init. Br. at 4. Staff also accepts the Companies' *pro forma* adjustment to the reserve for accumulated depreciation, which is limited to depreciation on the plant additions. *Id.* at 5.

The reserve for accumulated depreciation is the major offset to plant in service in determining net plant – the rate base used in setting rates. However, the Companies' and Staff's proposed depreciation adjustment reflects only a portion of the change in the reserve for accumulated depreciation that is certain to occur over the period the plant additions are to occur. *See* City-CUB Init. Br. at 9-11. The GCI proposed a *pro forma* adjustment for accumulated depreciation that captures the known and measurable change in the reserve for accumulated depreciation through September 2007. With GCI's proposed change, the net plant used to set rates in this case will be "reflective of the costs and revenues that will be in place" for the period during which rates are effective – a characteristic the Companies agree is appropriate for *pro forma* adjustments. Sep. 10, 2007 Tr. at 130.

The Companies' Initial Brief misreads relevant Commission precedent on the appropriateness of adjustments that offset post-test year plant additions. It also contains errors respecting Mr. Effron's proposed *pro forma* accumulated depreciation adjustment. *See* PGL-NS Init. Br. at 18-21. In our Initial Brief, City-CUB detailed the Companies' strained misreading of the Commission's *pro forma* adjustment rule and Commission precedent that undergird the

Companies' testimony. *See* City-CUB Init. Br. at 11-13. In this Reply Brief, City-CUB will address particular additional arguments raised in the briefs of Staff and the Companies.

The Companies argue, somewhat surprisingly, that matching accumulated depreciation over the same period as the Companies' *pro forma* additions to plant in service is "inconsistent with test year principles and the Commission's *pro forma* adjustments rule." PGL-NS Init. Br. at 3. It is for precisely these reasons that the Companies' one-sided, single-issue proposal must be rejected. The Commission's *pro forma* adjustment rule, which defines an exception to its test year rule, contemplates adjustments for "known and measurable" changes from test year operating results – not just increases favorable to utilities. *See* 83 Ill. Adm. Code § 287.40. The rule directs:

> adjustments *shall reflect changes affecting the ratepayers* in plant investment, operating revenues, expenses, and cost of capital where such changes occurred during the selected historical test year or are *reasonably certain to occur* subsequent to the historical test year within 12 months after the filing date of the tariffs and *where the amounts of the changes are determinable*.

Id. (Emphasis added.)

The Commission decisions construing its *pro forma* adjustments rule infuse that language with a substantive policy of assuring that *pro forma* costs and revenues are more reflective of those during the period rates will be in effect than unadjusted test year data. In fact, the Commission has rejected *pro forma* adjustments that created results not "representative of net plant in service when the rates go into effect." *In re Central Ill. Light Co.*, ICC Docket No. 02-0837, Order at 8 (Oct. 17, 2003) ("*Central Illinois*"). In *Central Illinois*, the utility's proposal for *pro forma* plant additions failed to account for changes in accumulated depreciation. In pursuing its substantive representativeness policy, the Commission has taken a number of specific actions that affirm the policy. In various cases, the Commission has:

» denied *pro forma* adjustments offered without taking account of offsetting known and measurable depreciation changes – *Central Illinois* at 8 – ("The Commission is of the opinion that the *pro forma* adjustments should not be approved. The net plant in service balance at the end of the 2001 historical test year appears to be more representative of net plant in service when the rates go into effect");

» rejected *pro forma* adjustments to the reserve for accumulated depreciation that did not match the period of *pro forma* plant additions – *In re Illinois Power*, ICC Docket No. 01-0432, Order at 20-21 (Mar. 28, 2002) (the Commission ordered "recognition of accumulated depreciation and deferred taxes on plant in service as of December 31, 2000, through September 30, 2001, . . . consistent with . . . capital additions for projects that have received funding approval as of September 30, 2001); and

» required additional adjustments in conjunction with *pro forma* additions to plant in service so that the utility earned only on the plant value properly included in rate base – *In re Union Electric* ICC Docket No. 03-0009, Order on Rehearing at 6 (May 5, 2004) at 6 (*quoting* Section 9-211 of the PUA).

The Commission has also approved proposals inconsistent with the principle of balance that is codified as the test year rule. *See, e.g., In re Commonwealth Edison*, ICC Docket No. 05-0597, Order at 15 (Jul 26, 2006). But, the Companies' contention that disparate treatment of Mr. Effron's proposed *pro forma* depreciation adjustment is required because it takes account of depreciation on more than the Companies' selected capital additions is not supported by the Commission's decisions. The decisions cited by the Companies do not involve the specific adjustments and unusual circumstances at issue in this case.[4]

[4] It is difficult to say how the Companies' irrational reading of Commission precedent (*see* City-CUB Init. Br. at 11-13) might apply in these cases. However, it should be obvious that whether rate base is increasing, decreasing, or constant, *pro forma* adjustments that do not yield a result "representative of net plant in service when rates go into effect" cannot produce just and reasonable rates, and they should not be permitted.

The fact that the Commission's past decisions have not been consistent on this issue makes the facts of record crucial, if not decisive, in this case. The Companies agree that the Commission's decisions share a common mandate to give precedence in each case to the particular facts of the case. NS/PGL Ex. SF-4.0 at 6, L. 167; Sep. 10, 2007 Tr. at 129. Here, the anomalous levels of the proposed *pro forma* adjustments are an independent ground for denying the proposed capital additions (which City-CUB do not otherwise oppose). *See* City-CUB Init. Br. at 14-16. Those adjustments cannot be deemed reasonable unless offsetting known and measurable changes are also recognized. Otherwise, the *pro forma* plant additions will distort test year costs and revenues such that they are not representative of the period rates set in this case will be in effect. *See Central Illinois* at 8. Indeed, they would be less representative than the unadjusted test year data.

Illinois courts have given an even stricter meaning to the constraints of the Commission's test year rules. In reversing Commission approval of outside-test-year adjustments accomplished through a rider, the Illinois Supreme Court reviewed the purposes and meaning of the Commission's test year rules.

> In determining the amount of money a utility is authorized to collect from the consumers, the Commission is required to consider all aspects of the utility's operations during a year selected by the utility as a test year. The test year so selected is intended to be representative of both the utility's anticipated rate-base expenses and its expected revenues, including overall costs and rate of return in the same year. Here, instead of considering costs and earnings in the aggregate, where potential changes in one or more items of expense or revenue may be offset by increases or decreases in other such items, single-issue ratemaking considers those changes in isolation, ignoring the totality of circumstances. Addressing this issue, the supreme court in *Business & Professional People for the Public Interest v. Illinois Commerce*

Comm'n (1991), 146 Ill. 2d 175, 244-45, 585 N.E.2d 1032, 166 Ill. Dec. 10 (*BPI II*), stated:

> 'The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the aggregate costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Often times a change in one item of the revenue formula is offset by a corresponding change in another component of the formula. For example, an increase in depreciation expense attributable to a new plant may be offset by a decrease in the cost of labor due to increased productivity, or by increased demand for electricity.

A. Finkl & Sons Co. v. Illinois Commerce, 250 Ill. App. 3d 317 (1 Dist. 1993) at 325-26 ("*Finkl*"). Thus, the Companies' proposed one-sided adjustments for plant additions, without consideration of concurrent, offsetting changes to rate base, violate the representativeness standard of the Commission's test year and adjustment rules, as well as the legal prohibition against single-issue ratemaking.

The Companies' implicit assertion that their selection of *pro forma* adjustments somehow limits the offsetting adjustments that can be considered (PGL-NS Init. Br. at 19) is not supported in the stricter view of the Illinois Supreme Court. Also, the Companies' position would nullify the Commission's substantive policy goal of including representative data for the period during which rates will be in effect. That is, the policy is nullified if the Companies are permitted to make selective, one-sided *pro forma* changes that encompass only items that result in significant net increases in rate base or revenues for the Companies. Such one-sided proposals are the precise circumstances the Commission was compelled to address with its policy-driven interpretations of the *pro forma* adjustment exception to test year principles.

At the evidentiary level, the Companies hint at other adjustments that they could have made, but they have neither identified nor proposed any other adjustments to achieve the fairness they say is missing with Mr. Effron's proposed depreciation adjustment. For his part, Mr Effron omitted calculations of other adjustments because, in his view, they are not material in effect. GCI Ex. 5.0 at 4, L. 81-83. His determination is wholly unchallenged by the Companies or Staff.

The Companies also argue that Mr. Effron's adjustment is a general attrition adjustment. PGL-NS Init. Br. at 20. It is not. Contrary to the Companies' argument, Mr. Effron's depreciation changes are known and measurable, as they can be calculated with specificity from the Companies' approved depreciation rates, the Companies' 2006 test year amounts, and the Companies' *pro forma* capital additions – a fact confirmed by the Companies' witness, Mr Fiorella. Sep. 10, 2007 Tr. at 134-135.

The Companies' proposed *pro forma* adjustments for plant additions establish a period of time over which offsetting rate bases changes must be considered to respect the balance and representativeness codified in the Commission's rules. It is sheer sophistry to characterize Mr. Effron's proposal to adjust accumulated depreciation, in accordance with the Commission's *pro forma* adjustments rule, as "switching test years," while calling the Companies' own proposal to adjust plant in service over precisely the same period "*pro forma* adjustments." PGL-NS Init. Br. at 19. Allowing the utility's self-serving selection of *pro forma* adjustments to limit application of the Commission's rule to other known and measurable changes subordinates the rule to utility discretion. Moreover, it is inconsistent with the Commission's own rule for limited exceptions to its test year rules and distorts the balance of costs and revenues that the test year rules enforce.

II. RATE BASE

G. OPEB Liabilities and Pension Asset/Liability

In their Initial Brief (at 3), the Companies attempt to portray their routine pension plan activity as similar to the unusual action Commonwealth Edison took to correct a significant under-funding of its pensions. *See In re Commonwealth Edison Co.*, ICC Docket No. 05-0597, Order at 28-29 (July 26, 2006). That utility's extraordinary contribution (approximately $800 million) bears little resemblance to the pension charges, incurred by the Companies in the routine course of operations, that are at issue here. In *ComEd*, the amount at issue was clearly in excess of what could plausibly have been ratepayer-funded. Without such a basis, the Commission's unique response to the Commonwealth Edison restorative contribution cannot be supported here. (ComEd was allowed to recover the cost of debt that was issued specifically for the purpose of financing the pension fund contribution. *Id.*) The Companies have not presented any evidence of special circumstances that warrant a deviation from the Commission's established position on pensions – either as to the treatment of the Companies' OPEB liabilities or the exceptional proposal to include the net pension asset in rate base.

III. OPERATING EXPENSES

C. Contested Issues

3. Administrative & General Expenses

b. Incentive Compensation Expenses

Staff's Initial Brief presents a comprehensive review of the sequence of proposals by the Companies and the substantive evidence of the parties. *See* Staff Init. Br. at 34-36. The Companies' proposed incentive compensation cost recovery proposals fail to meet the substantive and evidentiary requirements of Commission precedent. The evidence offered in support of the Companies' proposals is riddled with uncured deficiencies. The Companies' effort to mitigate those deficiencies consisted of a series of incremental reductions in the costs they seek. *See id.* at 36-37.

Recognizing the overbreadth of their original request to include all their incentive compensation costs among allowed test year expenses, the Companies emphasize their "Plan B" – recognition of expenses that are nominally related to some aspect of service to customers. PGL-NS Init. Br. at 47. However, the evidence of record regarding any such relationship does not show the quantified, tangible benefit to ratepayers required for recovery of those costs. The evidence of record is unchanged, and the Companies have identified nothing City-CUB did not consider and address in our Initial Brief. *See* City-CUB Init. Br. at 18-21.

Stretching their arguments far past any reasonable limit, the Companies attempt to treat their challenged expenses as substitutable by other less objectionable – but equally unproven – expenses. "[U]nder the Staff and GCI positions, the amounts of incentive compensation that they challenge would not be challenged if the Utilities had paid the exact same amounts of total compensation but had made the incentive compensation amounts part of base pay. . . . In light of this testimony, the Utilities' challenged incentive compensation costs merit full recovery through rates." PGL-NS Init. Br. at 49. Contrary to this novel ratemaking theory, each proposed cost of service must be justified as the cost it is – not recast as allowable simply because the challenged amount is less than the cost of something different that might be allowed.

The Commission has established a clear evidentiary test for determining prudent and reasonable incentive compensation costs. *See* City-CUB Init. Br. at 18-19. The Companies' bare list of decisions allowing incentive compensation costs adds nothing to the assessment of record evidence against the Commission's evidentiary standards. PGL-NS Init. Br. at 53. The Companies cannot unilaterally redefine the Commission's standards, and the evidence the Companies do present does not meet those standards. Therefore, the incentive compensation costs should not be allowed.

4. Invested Capital Taxes

Staff accepts the Companies' *pro forma* test year capital structure as evidence of an otherwise-unstated dividend policy for the future. Staff Init. Br. at 40. The Companies acknowledge that their capital structures have varied considerably in recent years from that proposed *pro forma* structure. PGL Ex. BAJ-1.0 (Rev.) at 6, L. 112-19; NS Ex. BAJ-1.0 (Rev.) at 6, L. 111-20. Indeed, the structure of 54% common equity and 44% debt proposed here is not even the actual NS capital structure for the test year. NS Ex. BAJ-1.0 (Rev.) at 6, L. 111-13 City-CUB do not challenge the Companies' use of that test year capital structure. But, the Companies have not provided any firm evidentiary basis for the Companies' and Staff's assumption that the *pro forma* capital structure will be in place when Invested Capital Taxes are computed using the Companies' actual retained earnings and total capitalization amounts. GCI Ex. 2.0 at 34, L. 763-68.

Without a single statement from the Companies' many witnesses providing an evidentiary basis for their assumption that the Companies will maintain (or, in the case of North Shore, achieve) the *pro forma* capital structure, the Companies and Staff compute a *pro forma* Invested Capital Taxes expenses adjustment on that basis. When asked, the Companies' witness declined to articulate a policy on which the Commission might rely, preferring instead merely to restate what the Companies have assumed. Sep. 10, 2007 Tr. at 121-122. Such assumptions do not constitute evidence that is adequate to establish the Invested Capital Taxes amounts so computed as a "known and measurable" quantity under the Commission's rules for *pro forma* adjustments. 83 Ill. Admin. Code § 287.40.

IV. RATE OF RETURN

C. Cost of Common Equity

1 & 2. Peoples Gas/North Shore

a. Comparisons of ROE Estimates

Each of the parties making an ROE recommendation in this case has sought to bolster its own recommended ROE by noting its similarity to another estimate. City-CUB witness Mr. Thomas noted the similarity of the primarily objective, unadjusted DCF estimates produced by him and Ms. Kight-Garlisch. City-CUB Init. Br. at 33. Staff cites the similarity of its recommended ROE to an artificial amalgam of an average of two of the Companies' four estimates, without certain selected adjustments. Staff Init. Br. at 52. In their Initial Brief, the Companies are equal to Mr. Moul in their dedication to comparisons to other commission's ROE awards, without regard to the facts of record in this proceeding.[5] *See* PGL-NS Init. Br. at 56-57, 91-92.

In another context, the Companies clearly recognize the flaws in such comparisons to other commission actions:

> Mr. Glahn's S.C. No. 1 proposal is arbitrary and he offers no analysis or justification for it, except casually comparing it to the customer charges of other Utilities. Mr. Glahn has not performed a cost study for the Utilities nor has he provided any analysis of the other utilities rate designs, costs underlying their rates, or any reasoned discussion of how they have been developed or how they specifically compare with Peoples Gas' rates or why such a comparison is relevant.

Id. at 167-68. (In this criticism, the Companies ignore Mr. Glahn's testimony regarding possible rate shock and the objective of gradualism in rate design as additional bases for Mr. Glahn's proposal for moderated increases in monthly charges.)

While similarity to a valid ROE estimate can lend confidence to the Commission's decision on this issue, the items compared must themselves be relevant, valid estimates. On this point the comparisons of Staff and the Companies fail. The deficiencies of the recommended ROEs of Staff and the Companies individually were detailed in City-CUB's Initial Brief. City-CUB Init. Br. at 22-47. It flatters neither comparative when Staff's Initial Brief likens (a) Staff's average of a DCF estimate and a flawed CAPM estimate more than 300 basis points higher with (b) the Companies' own average of three widely dispersed estimates from improperly boosted model analyses, "checked" by a fourth estimate some 450 basis points above their lowest estimate. Staff Init. Br. at 52.

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5 Specifically, the Companies complain that the ROE recommendations of City-CUB and Staff are "lower than those set for other utilities around the country in recent years;" and unreasonable "by comparison to the information [on other awards] relied upon by sophisticated investors." PGL-NS Init. Br. at 5; *see also id* at 90-92.

As in other aspects of Mr. Moul's ROE analyses, he turns again and again to other commissions that have behaved on ROE determinations as the Companies wish this Commission will act. They ask that this Commission unlawfully follow their lead, without regard to the evidence of record. *See* 220 ILCS 5/10-201(e)(iv)(A). If, as the Companies contend, it is beyond dispute that commission ROE decisions influence investors (PGL-NS Init. Br. at 91), then the effects of that information will already be reflected in share prices and other market data. Instead, Mr. Moul makes matching the actions of other commissions his Holy Grail – his highest objective, which trumps the results from any analytical examination of objective market information. *Id.*

Ultimately, the determination of an appropriate ROE must rest on the evidence of record supporting particular ROE recommendations. The record shows the City-CUB estimates and recommendation to be superior.

b. Technical Issues

The reviews of ROE analyses in the Initial Briefs of Staff and the Companies focus mainly on technical elements of the various analyses. Staff's review of Mr. Moul's ROE estimate, however, criticized only two of the many adjustments he made to the fundamental model methodologies he employed – his flotation and leverage adjustments. One or both of those adjustments were applied to the final results of his DCF, CAPM and risk premium analyses. Staff ignored other inappropriate adjustments embedded in Mr. Moul's models, likely because they are improper adjustments that Staff witness Ms. Kight-Garlisch also made in her analyses. *Compare* Staff Init. Br. at 59 *with* City-CUB Init. Br., App. A. The major points of criticism in the briefs of Staff and the Companies are assessed below.

i. DCF vs. CAPM

Staff disputes that the DCF model is "superior," in some evidentiary sense, to the CAPM, an assertion Staff attributes to Mr. Thomas. Staff Init. Br. at 66. Mr. Thomas's actual position is that the DCF model relies more on objective market factors and less on subjective determinations of investors or the analyst – making it "most objective and less susceptible to manipulation." CUB-City Ex. 2.0 at 3, L. 52-53. It is that characteristic (undisputed on this record), coupled with the serious theoretical and practical problems inherent in the CAPM, that makes the DCF estimates more useful to the Commission. *Id.* at 13, L. 310-13 (the relatively consistent unadjusted DCF results from the experts in this case "suggest that the DCF – regardless of the perspective of the analyst – is more apt to produce a valid reflection of the economic circumstances determining investor requirements for utility companies").

One deficiency of the CAPM that is especially relevant in this case is the deliberate exclusion of non-systematic risk factors from its ROE estimation. It is a fundamental premise of the CAPM methodology that non-systematic risks peculiar to a specific utility – like the revenue assurance riders requested by the Companies – have no effect on its required ROE ; such factors are, therefore, given no consideration in the CAPM analysis. *See* CUB-City Ex. 1.0 at 40, L. 986-92; *see also id*. at 40, L. 976-84. (Mr. Thomas took account of this and other deficiencies of CAPM by using it only as a check on his DCF estimate, and by recommending that the Commission also use it for the same limited purpose. CUB-City Ex. 2.0 at 7, L. 166-67; *see also* CUB-City Ex. 1.0 at 41, L. 1023-26.)

The ROE recommendations of both Staff and the Companies cannot stand without averaging in their CAPM estimates. Yet, in their expressed opinions respecting a central issue in this case – the proposed riders – Mr. Moul, Ms. Kight-Garlisch, and Mr. Thomas each reject the fundamental premise of the CAPM analysis that risks peculiar to a utility do not affect its required ROE (because it can be diversified away). *See* PGL Ex. PRM-1.0 (Rev.) at 6, L. 118-26. Mr. Moul acknowledges the relevance of the riders to an appropriate ROE determination, but opines that the effect of the riders is captured through the proxy group used for his DCF analysis. NS-PGL Ex. PRM-2.0 (Rev.) at 22, L. 479-83 . He does not address the riders in his CAPM analysis. Mr. Thomas and Ms. Kight-Garlisch each testified that approval of the riders would mean less risk and a lower required ROE. CUB-City Ex. 1.0 at , 63-64, L. 1556-60; Staff Ex. 6.0 at 23, L. 425-29. Staff nonetheless bases its recommendation equally on its CAPM and DCF analyses. *See* City-CUB Init. Br., App. A.

ii. ROE Effect of the Proposed Riders

The Companies argue in their Initial Brief that there is no evidence that the proposed riders will have an effect on investors' required return. PGL-NS Init. Br. at 87. That conclusory declaration and similar ones in testimony (*see*, *e.g.*, NS/PGL Ex. PRM-1.0 (Rev.) at 6-7, L. 134-137) are insufficient to counter the quantitative evidence challenging that assertion, especially since it is the Companies that have the statutory burden of proof. City-CUB Init. Br. at 47. In their Initial Brief, the Companies provide no citations to objective or quantitative evidence of record to support their assertion, while making questionable CAPM theory (about firm-specific risk factors) central to their position on the ROE effect of the riders. PGL-NS Init. Br. at 87. The Companies' claim that "the majority" of Mr. Moul's DCF proxy sample have "similar" mechanisms is unsupported by an examination of the particulars on the record. *See* City-CUB Init. Br. at 46-47.

On the other hand, there is considerable evidence that the riders will have a significant effect on investors' required ROE. There is PGL's parent firm's willingness to pay for insurance to achieve a lesser revenue effect (with derivative ROE effects) than the riders would provide. *See id.* at 47. There is the "backcast" analysis performed by the Companies, which shows that had only one of the proposed riders (VBA) been in effect for a single year, the Companies would have realized an additional $30 million in revenues. *Id.*

The Companies nonetheless make a new argument in brief – that the riders are "risk neutral" because they "protect shareholders and customers alike." PGL-NS Init. Br. at 87. The additional revenues identified by the Companies' "backcast" analysis (a $30 million increase in customer charges) demonstrate that the riders are not risk-neutral from customers' perspective. *See* City-CUB Init. Br. at 47. Moreover, the fact that the Companies have proposed the riders belies any pretense that they are risk-neutral. There would be no point in proposing a rider that would have a "neutral" effect on today's risk allocation, where "shareholders and customers alike" are unprotected.

The Companies' latest arguments against Mr. Thomas's use of the weather insurance policy, as a proxy for quantifying the ROE effect of the riders, actually validate his methodology. First, the Companies argue that adding a refund feature for customers to its actual policy would have made the policy "akin to Rider VBA requiring refunds." PGL-NS Init. Br. at 89-90. Thus, the weather insurance policy is deemed a valid proxy, with one difference. Mr. Thomas acknowledged that policy difference, but did not deem it consequential, since Rider VBA will almost certainly work to benefit the Companies, not their customers, despite its "symmetrical" structure. *See* Sep. 12, 2007 Tr. at 1097-98. The Companies argue that Mr. Thomas should have discounted the value of the policy by the probability of a payout. In Mr. Thomas's view, his calculation did just that, given the "near certain payout of the riders," which offer much greater protection of shareholder interests than did the weather insurance policy. *Id.* Indeed, Mr. Thomas's proxy analysis yields a <u>conservative</u> estimate of the reduction in the required ROE stemming from approval of the proposed riders. CUB-City Ex. 1.0 at 67-68, L. 1653-55.

iii. Adjustment of CAPM Betas

Staff argues that "Mr. Moul and Ms. Kight-Garlisch both correctly used adjusted betas instead of raw betas." Staff Init. Br. at 66. In support of that argument, Staff reports a divergence between unadjusted betas and the resulting CAPM estimates. *Id.* Staff's solution, however, is to impose the effect of market-level risk on less risky utility equity, despite empirical evidence that utility beta reversion is not to the market, but to a distinct utility mean. NS/PGL Ex. PRM-2.0 (Rev.) at 31, L. 686-88; Staff Ex. 18.0 at 19, L. 383-86; CUB-City Ex. 1.0 at 47, L. 1154-56. Ms. Kight-Garlisch argues that adjusting betas to mimic a reversion to the market beta of 1.0 produces a result that "more closely conforms to the CAPM prediction." Staff Init. Br. at 66. But, that argument assumes that the CAPM prediction is the appropriate ROE estimate. More to the point, it says nothing to dispute Mr. Thomas's testimony that the CAPM prediction is flawed and does not warrant equal weight with the DCF estimates, shorn of any biased modifications.

iv. Quarterly Dividend Adjustment

Mr. Thomas's testimony explains why a utility receiving an unadjusted ROE provides its investors with the authorized annual return, whether dividends are paid annually or quarterly. Instead of assessing whether investors receive their required ROE without her adjustment, Ms.

Kight-Garlisch focuses on the utility's cash on hand. The fact that the Commission previously (but not exclusively) has approved a quarterly adjustment should not be determinative. Mr. Thomas presented evidence demonstrating that the adjustment is unnecessary, and he expressly asked that the Commission re-examine its use of quarterly adjustments that unnecessarily increase costs to ratepayers. *See* City-CUB Init. Br. at 29-30.

Staff's response to Mr. Thomas with respect to the effect of a quarterly dividend adjustment centers on working capital and completely misses his point. The Commission-authorized ROE compensates investors for the risk of their utility investment. It is *not* about funds the utility has available to it during the year or about any diminution in funds attributable to quarterly dividend payments. Staff Init. Br. at 72. Dividends are paid from retained earnings, not working capital.[6] CUB-City Ex. 1.0 at 22, L. 507-09.

v. Significance of Market-to-Book Ratios

City-CUB emphasize that it is the Companies that bear the burden of proving that their proposed ROE is reasonable. The Companies have proposed a return on common equity that has been adjusted to maintain their current market-to-book ratios. *See* City-CUB Init. Br., App. A. Mr. Thomas's testimony provided evidence that relevant market indicators – market-to-book ratios in particular – demonstrate that the effect of the Companies' upwardly adjusted ROE perpetuates return levels that exceed market-required returns. CUB-City Ex. 1.0 at 24, L. 565-70; CUB-City Ex. 2.0 at 16, L. 374-78. In response, the Companies simply asked Mr. Thomas to identify theoretical, possible causes of their market-to-book excess. *See* PGL-NS Init. Br. at 72-

[6] Mr. Thomas noted that the riders will affect the Companies' cash flow, but in the context of a Discounted Cash Flow (DCF) analysis -- not as working capital. CUB-City Ex. 1.0 at 65, L. 1593-95.

73. They offered *no* evidence that any of these theoretical causes – instead of earnings in excess of market ROE requirements – are responsible for their market-to-book ratio.

Mr. Thomas acknowledged a number of the theoretical sources of a market-to-book ratio above 1.0. Sep. 12, 2007 Tr. at 1093. (Mr. Thomas does not attribute the observed upward bias in analysts' forecasts to a specific cause; he reports the findings of empirical research.) Of those possible causes, the record does establish that one – the Companies' earnings in excess of their authorized return levels for several years in the period since their previous rate case – is present (and relevant) in this case. GCI Ex. 1.0 at 19, Table 1. The Companies, in contrast, have offered no evidence that incentive return awards from this Commission, rewards for excellent management, or market inefficiencies (Sep. 12, 2007 Tr. at 1093) have actually affected their market-to-book ratio. Nor have they quantified the extent (if any) to which this Commission's ratemaking practices (*id.* at 1092) may have affected their market-to-book ratios. Without at least some evidence that their theoretical justifications (*see* PGL-NS Init. Br. at 72-73) actually apply in this case, Mr. Moul's leverage adjustment to perpetuate that ratio is unsupported on this record and cannot be accepted.

Staff summarizes the theoretical causative factors the Companies identified into two descriptive categories – (a) "the investor-required rate of return has fallen" (because of various factors) or (b) "expectations of future earnings have risen." Staff Init. Br. at 62. In the first case, Staff concludes "it obviously follows that the Commission should authorize a lower rate of return." *Id.* The City and CUB agree. In the second case, investor expectations may be affected by "positive deviations from the test year amounts on which . . . rates are set." Staff concludes that the Commission should not allow higher returns based on higher stock prices due to greater-than-expected sales of service, additional revenues due to unregulated operations, or accounting effects of the ratemaking process. *Id.* In its rejoinder to this testimony from Ms. Kight-Garlisch, the Companies say nothing that undermines Ms. Kight-Garlisch's point that external factors that serendipitously increase earnings above the authorized level – including "the market value of assets that exceed book value" (PGL-NS Init. Br. at 72) – should not be the basis for perpetuating the increase through higher authorized returns, unless they are components of firm market requirements.[7]

In sum, maintaining returns above those required by the market is neither a prudent action nor a reasonable cost. Staff's brief contains an illustration of the deadly – to ratepayers – spiral of increasing ROE awards that would ensue from adoption of the leverage adjustment that Mr. Moul proposes. *See* Staff Init. Br. at 64-65.

vi. Bias of Growth Rate Forecasts

The Companies' arguments opposing, despite the reported empirical findings, Mr. Thomas's evidence of an upward optimism bias in analysts' growth forecasts are essentially that (a) utilities could be different or (b) the accuracy of forecasts is irrelevant. PGL-NS Init. Br. at 74. As to the first point, the Companies cite no evidence for concluding that the findings do not apply to utilities. In making the second argument, the Companies accept the extreme subjectivity of Moul's analyses, since his aim is to identify "expectations" – not market-required returns, as indicated by achieved returns that actually induced capital investments. If that is the aim, then

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[7] In its zeal to criticize Mr. Thomas's valid observations about the meaning of market-to-book ratios in the ROE context, Staff contradicts itself, by ignoring its more substantive observations about market-to-book ratios noted above. *See* Staff Init. Br. at 73.

truly "the rationality of investors' true growth expectations is not at issue." *Id.* (internal quotations omitted).

c. Objective vs. Subjective ROE Estimates

The Companies are far too literal in their reading of the Commission's remarks about ROE and "the investor." *See* PGL-NS Init. Br. at 57-58. City-CUB submit that the Commission's use of that phrase was in the sense that Mr. Thomas explained is common among experts in the field. That meaning – shorthand for the aggregate position of all investors as indicated by objective market factors – is the only lawful interpretation of the Commission's words. City-CUB Init. Br. at 35-36. The Companies' alternative meaning – the subjective personal expectations of some particular investor(s) – would have the Commission rely on factors that need not reflect the reasonable and prudently incurred cost of capital that is represented by *market requirements* rather than *subjective expectations*. The Companies' reference to "unchallenged evidence of actual investor expectations" (*id*. at 59) is offered without a record citation. It is unclear what such evidence would be, but this record does not contain any such "unchallenged" evidence.

The Companies also try to salvage their subjective-expectations ROE request by improperly expanding the meaning of other Commission language. *See* PGL-NS Init. Br. at 58-59. The Commission's acknowledgment that ROE analyses require "the analyst's informed judgment" does not validate all possible sources of informed judgment as bases for ROE determinations. It does not validate the Companies' favorite source of information – other commissions' ROE determinations for other utilities, on other records. It also does not extend the application of such judgment outside accepted analytical models or methodologies.[8] Moreover, the application of informed judgment in using financial models is not the same as looking at Commission orders to determine what ROE will meet subjective investor expectations.[9]

D. Flotation Costs

Ms. Kight-Garlisch joins Mr. Thomas in recommending rejection of Mr. Moul's proposed flotation adjustment. *See* Staff Init. Br. at 75. As City-CUB pointed out in their brief, the clear standards established by Commission precedent on this issue and the Companies' failure to meet those requirements require that that adjustment be rejected. City-CUB Init. Br. at 48-50. It is undeniable on the facts of this case that no flotation adjustment is appropriate. For more than a decade, the Companies' excess of market value over book value has provided the utilities with all the flexibility needed to access the equity capital markets without diluting existing shares. With an excess of earnings over the Companies' authorized returns in many years, the Companies likely have fully recouped the costs they identify as unrecovered.

The Companies' Initial Brief offers nothing new. As in testimony, they ask for recovery of flotation costs that, on the evidence, are not certain to be incurred or already incurred but unrecovered. The Companies do not even assert that they incurred flotation costs in the test year or will incur them in the near future. The Companies also appear to believe that a utility earning

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[8] Even within analyses, using averages of widely disparate results and ROEs of other utilities to "pinpoint" an ROE estimate is dubious, especially when the heart of the estimates are accounts of extra-record decisions that are not relevant to the constitutional risk factors of these utilities. PGL-NS Init. Br. at 91-92.

[9] A list of other commission decisions may be objective, as they are what they are, but it is not relevant absent some showing of similar risk and circumstances. *See, e.g.*, *In re Commonwealth Edison Co.*, ICC Docket No. 05-0597, Order at 153 (July 26, 2006). The Companies have offered only its witness's assertion that all are utilities.

above its authorized return has unrecovered flotation costs unless it receives a check denoted "unrecovered flotation costs." PGL-NS Init. Br. at 93. They provide no other evidence that the identified flotation costs are in fact unrecovered.

V. HUB SERVICES

In our Initial Brief, the City and CUB demonstrated that the Commission should adopt CUB-City witness Jerome Mierzwa's proposal that Peoples Gas be required to "optimize the entirety of Manlove field's storage capacity for ratepayers by including all available storage in the gas dispatch model." CUB-City Ex. 3.0 at 7, L. 160-62. Neither Staff nor the Companies discuss Mr. Mierzwa's proposal in their respective Initial Briefs. However, Staff catalogs the various ways in which Peoples Gas failed to perform the necessary, prudent inquiries or studies needed to determine the best use of its storage facilities, including Manlove. Staff Init. Br. at 81-82. These facts are the genesis of Mr. Mierzwa's recommendation that the disposition of the storage capacity be determined on the basis of such a study, using the best available tool for that task – PGL's gas dispatch planning model. *See* CUB-City Ex. 3.0 at 7, L. 160-65. Since, as Staff acknowledges, PGL could use its storage, including Manlove, to serve as a physical hedge for the benefit of ratepayers (Staff Init. Br. at 88), City-CUB reiterate that the Commission should preserve its options respecting the disposition of the Manlove capacity until a proper study is conducted to determine the optimal use of Manlove on behalf of ratepayers.

VI. WEATHER NORMALIZATION

Although Staff appeared to accept a ten-year normalization period in testimony, it is silent on the issue in its Initial Brief. Staff expresses neither support for nor opposition to the

Companies' proposal to change the Commission's historical normalization practice. Staff Init. Br. at 123.

In their Initial Brief, the Companies assert that Mr. Marozas showed that his proposed ten-year period is a better predictor of weather one year out, as well as two, three, four, and five years out. PGL-NS Init. Br. at 107. However, Mr. Marozas's testimony leaves considerable doubt that his statistical constructs actually simulate the decision the Commission must make. The Commission is not selecting a weather predictor for single years one, two or three years hence; it must determine normal climate conditions for an indefinite period. *See* City-CUB Init. Br. at 64. Recall that the Companies' current rates have been in effect for more than a decade. Despite the Companies' suggestion (*see* PGL-NS Init. Br. at 107-08), data from thirty years ago does not reflect weather that will never recur. Sep. 12, 2007 Tr. at 850. And, the climate change the Companies' witness Dr. Takle describes is not instantaneous; nor is it identifiable as occurring at a single point in time. The spasmodic nature of climate change does not support approval of the Companies' theory that climate will move only forward and from a date arbitrarily determined to be ten years in the past. *See* City-CUB Init. Br. at 61-62.

The Companies' arguments ignore all impacts on others of their proposed change in Commission normalization practice. The adverse effects on the Commission, on other utilities, and on customers are not addressed at all in the Companies' Initial Brief, despite the testimony demonstrating those effects. *See* City-CUB Init. Br. at 68-70. Their arguments also mix the testimony of Dr. Takle and Mr. Marozas as though one actually had something to do with the work of the other. *See* PGL-NS Init. Br. at 106-07. The testimony of each of the Companies' experts makes clear that is not the case. Such valued mutual support exists only in the

Companies' brief. *See* City-CUB Init. Br. at 64-66 (showing that Mr. Marozas's statistical study was uninformed by Dr. Takle's expertise and that the climate scientist's opinion on inputs for ratemaking is entirely uninformed by regulatory expertise). The evidence of record is inadequate to support the utilities' proposed drastic change in the Commission's normalization practice.

VII. NEW RIDERS

A. Overview

As part of their filing in these cases, Peoples Gas and North Shore request approval of several non-traditional rate recovery mechanisms. In particular, both utilities asked the Commission to approve Rider VBA, Rider UBA and Rider EEP. In their rebuttal case, the Companies proposed Rider WNA as an alternative to Rider VBA. In addition, Peoples Gas asked the Commission to endorse Rider ICR.

In our Initial Brief, the City and CUB presented a summary of case law describing the ratemaking process in Illinois. City-CUB Init. Br. at 75-76. Generally, Illinois courts have held that utility costs must be recovered through rates set in base rate cases. *See e.g.*, *Citizens Utilities Co. v. Ill. Comm. Comm'n*, 124 Ill.2d 195, 200-01 (1988) ("*Citizens Utility*") ("In establishing the rates that a public utility is to charge its customers, the Commission bases the determination on the company's operating costs, rate base, and allowed rate of return."); *Finkl*, 250 Ill. App. 3d at 325 ("In determining the amount of money a utility is authorized to collect from the consumers, the Commission is required to consider *all* aspects of the utility's operations during a year selected by the utility as a test year.")

We also showed that, except in unusual circumstances, Illinois courts have held that the Commission must consider a utility's full range of costs in setting rates. City-CUB Init. Br. at

76-77. Considering rates in isolation violates the rule against single-issue ratemaking. *See e.g.*, *Business and Professional Peoples for the Pub. Interest v. Ill. Comm. Comm'n*, 146 Ill. 2d 175, 244 (1991) ("*BPI II*") ("The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the *aggregate* costs and demand of the utility. ... Often times a change in one item of the revenue formula is offset by a corresponding change in another component of the formula.").

Finally, we demonstrated that in proper cases, the Commission has the authority to permit recovery of specific costs outside of base rate proceedings. City-CUB Init. Br. at 77-78. Recovery of such specific costs is through rider mechanisms. Illinois courts have held that rider recovery is limited to costs that are volatile, fluctuating and beyond the control of the utility. *See, e.g.*, *Finkl*, 250 Ill. App. 3d at 327 (riders are permissible where the costs in question are "*unexpected, volatile* or *fluctuating*" and beyond the control of the utility); *Citizens Utility Board v. Ill. Comm. Comm'n.*, 166 Ill. 2d 111, 138-39 (1995) ("*CUB*") (utility costs to remediate manufactured gas plant sites are "uncertain and variable" and, thus, appropriate for rider recovery). The *Finkl* court added that because the costs at issue in that case failed to meet the criteria for rider recovery, the rider violated the rule against single-issue ratemaking. *Finkl*, 250 Ill. App. 3d at 327, 330-31.

Staff presented a similar review of Illinois case law in its Initial Brief. Staff Init. Br. at 123-52. While Staff's brief is more thorough, Staff reached the same conclusion that the City and CUB reached in our brief with respect to rider recovery – "a rider mechanism is effective and appropriate for cost recovery when a utility is faced with unexpected, volatile, or fluctuating expenses." Staff Init. Br. at 151, *citing CUB*, 166 Ill. 2d at 138-39.

In its analysis of the relevant case law, the AG came to the same conclusion, citing the *Finkl* court's holding that "riders are useful in alleviating the burden imposed upon a utility in meeting *unexpected, volatile* or *fluctuating* expenses." AG Init. Br. at 33, *quoting Finkl*, 250 Ill. App. 3d at 327. Perhaps more importantly, the AG pointed out that the Companies' main witness regarding rider recovery, Russell A. Feingold, stated that he "believes that a ratemaking mechanism that provides for periodic rate adjustments to recover certain base rate components should be considered as an appropriate regulatory method when it addresses costs that are: (1) uncontrollable by the utility; (2) variable and unpredictable; and (3) material in nature." AG Init. Br. at 34, *quoting* GCI Ex. 1.0 at 17, L. 10-13.

Indeed, the Companies agree that the relevant criteria for approving rider recovery for specific costs are "when costs vary widely and there are difficulties in making forecasts of the scope, costs and timing of eligible costs." PGL-NS Init. Br. at 109. While Peoples Gas and North Shore are correct regarding the applicable criteria, they go awry when they state "no party has introduced evidence" that their proposed riders are necessary for the Companies "to achieve reasonable financial performance and stability..." *Id*. at 108. To the contrary, there was ample evidence submitted by Staff witness Peter Lazare and GCI witness Michael L. Brosch that the proposed riders are neither warranted nor necessary for the Companies' financial health.

Indeed, the most salient fact demonstrating that the Companies' position is overstated and unsupported is that despite the presence of the alleged business "challenges" (*id*.) for a number of years, Peoples Gas and North Shore had not filed rate cases since 1995 – more than *twelve* years ago. If, as the Companies' main rider witness alleged, the changes in business conditions faced by Peoples Gas "necessitate a fundamental change to the traditional ratemaking process through the application of new ratemaking mechanisms in the form of the Rider VBA, the Rider UBA, and the Rider EEP to preserve Peoples Gas' financial health," (PGL Ex. RAF-1.0 at 3, L. 44-47; *see also* NS Ex. RAF-1.0 at 2, L. 40-44), then how were Peoples Gas and North Shore able to preserve their "financial health" so long between rate cases? The answer, of course, is that the Companies' rhetoric is overblown.

One need only look at the Companies' respective recent financial performance to confirm that Peoples Gas and North Shore overstated their case. Staff witness Peter Lazare testified that "Peoples Gas met or exceeded its approved rate of return seven out of eight years from 1996 until 2003. Over that same period, North Shore exceeded its authorized return six out of eight years, and as late as 2003 earned a return of 14.13%." Staff Ex. 8.0 at 6, L. 126-29.

Besides failing to show that the proposed riders are necessary to protect the financial health of the utilities, the Companies also failed to show that a radical change in the ratemaking process is warranted. Remember, Peoples Gas and North Shore are recommending there be "a ***fundamental change*** to the traditional ratemaking process through the application of new ratemaking mechanisms in the form of the Rider VBA, the Rider UBA, and the Rider EEP... " PGL Ex. RAF-1.0 at 3, L. 44-47; *see also* NS Ex. RAF-1.0 at 2, L. 40-44 (emphasis added). The record in this case does not support the complete overhaul in the regulatory process that the Companies desire. The fact that the Companies have avoided filing rate cases for more than twelve years while facing many of these same business challenges means that the "traditional ratemaking process" is not nearly as obsolete as Peoples Gas and North Shore would have one believe. And as Staff noted, the Companies' "consistent financial success undermines [their] claim that the traditional regulatory paradigm is broken and needs to be fixed." Staff Init. Br. at 156.

The Companies further claim that "the Commission has ***consistently*** employed rate tracking mechanisms in the form of riders, whether statutorily authorized, [citation omitted], or implemented by the Commission on its own initiative." PGL-NS Init. Br. at 109. In fact, most riders approved by the have implemented special rate treatments specifically authorized by statute – *viz.*, purchased gas adjustment and fuel cost adjustment riders. Non-statutory riders are relatively rare. To illustrate the Commission's "***consistent***" use of riders, the Companies cite the coal tar clean-up cases, *In re Investigation Concerning Issues Related to Coal Tar Cleanup Expenditures*, 137 P.U.R. 4th 272, 1992 WL 333219 (Ill. C.C. Sept. 30, 1992) (Docket No. 91-0080, *et al.*) and a Central Illinois Light Company case (*Central Illinois Light Company*, 124 P.U.R. 4th 498, 1991 WL 501759 (Ill. C.C. Aug. 2, 1991) (Docket No. 90-0127)). Citing only two cases hardly demonstrates the Commission's "***consistent***" use of riders. Moreover, the Companies cite *no* examples of Commission approval of simultaneously implemented riders with the vast scope of their proposals.

B. Rider VBA and WNA

1. Rider VBA Is Deficient in Several Respects and Should Be Denied.

Rider VBA is the Companies' "decoupling" rider and is designed to protect the portion of their respective revenue requirements that Peoples Gas and North Shore recover through volumetric charges. PGL-NS Init. Br. at 110. The rider would apply only to S.C. Nos. 1N, 1H and 2 customers and would establish a "baseline" of margin revenues for each such customer that the rider would protect. PGL Ex. VG-1.0 (2 Rev.) at 47, L. 1038-43; NS Ex. VG-1.0 (3Rev.) at 42-43, L. 933-38.

The Companies' primary argument in favor of Rider VBA is that decoupling mechanisms have been adopted or are being considered in several other jurisdictions. PGL-NS Init. Br. at 112-13, 116, 117. Staff thoroughly rebuts the Companies' assertion that the actions taken by other regulatory commissions should guide the Commission in this case. *See* Staff Init Br. at 176-81. Staff concludes that

> States that have approved decoupling mechanisms have done so with great apprehension, after thorough investigation and testing, and often at the behest of the legislature. These states have adopted revenue decoupling mechanisms, but either as pilot program, with safeguards, or both. In contrast, the instant Rider VBA does not have, nor have the Companies proposed, any safeguards to protect the ratepayers.

Id. at 181.

Moreover, in assessing the proposed riders, the Commission must first determine whether the costs at issue meet the criteria for rider recovery. Only after reaching that conclusion would the Commission decide whether to exercise its discretion to permit rider recovery. As to the first point, the Companies cannot claim that Rider VBA is designed to recover a volatile, fluctuating cost that is beyond their control because Rider VBA is designed to protect utility revenues and earnings, not to recover a particular cost. As Staff notes in its Initial Brief, that alone makes Rider VBA different from any rider approved by the Commission or Illinois courts. *Id*. at 166. Because the rider would adjust utility revenues outside of a rate case by, in effect, increasing rates when revenues are too low and decreasing rates when revenues are too high, Rider VBA would violate the rule against retroactive ratemaking. *Business & Professional People for the Pub. Interest v. Illinois Commerce Comm'n*, 136 Ill. 2d 192, 209 (1989) ("*BPI I*").

Even ignoring the fact that Rider VBA is designed to protect utility revenues and earnings and not to recover a unique cost, the record in these cases show that the Companies' respective revenues have not been volatile and fluctuating. Mr. Brosch included in his Rebuttal Testimony two tables showing the margin revenues for Peoples Gas and North Shore from 1996 through 2006. GCI Ex. 4.0 at 6, 7. The table relating to Peoples Gas's margin revenues (Table 6) shows that PGL's margin revenues have hovered around $400,000,000 per year for Peoples Gas over the entire 11-year period exhibited. *Id*. at 6, 7, L. 1-4. North Shore's margin revenues, as demonstrated in Table 7, have stayed around the $60,000,000 level for the same period. Even if one could lawfully protect utility revenues and earnings through use of a rider, the evidence indicates the Companies' respective revenues have not been volatile or fluctuating, as Illinois case law requires for rider recovery of specific costs. Thus, approving Rider VBA would violate the rule against single-issue ratemaking.

Peoples Gas and North Shore claim that Rider VBA should be approved because it does not shift any risk to ratepayers. *See* PGL-NS Init. Br. at 116. The evidence in the case contradicts this point. Staff witness Lazare presented the Companies' answer to an AG data request asking what revenue changes would have been experienced in the past five years if Rider VBA had been in place. The results unmistakably show that Rider VBA would have been a boon to the Companies.

YEAR	**PEOPLES GAS**	**NORTH SHORE**
2002	$43,924,875	$6,045,433

2003	$22,261,021	$1,560,702
2004	$39,568,443	$4,232,381
2005	$50,617,399	$5,634,208
2006	$61,899,211	$6,906,686

Staff Ex. 8.0 at 7, L. 151-56; GCI Ex. 1.3. Those numbers total to an additional $218 million in pre-tax operating income for Peoples Gas and an additional $24 million in pre-tax operating income for North Shore. GCI Ex. 1.0 at 37, L. 10-13. Mr. Brosch testified that based on the Companies' analysis of the rider's impact had Rider VBA been in effect for the past five years, Peoples Gas's margin revenues would have increased by about 11.2% and North Shore's margin revenues would have increased by 8.9%. *Id*. at 37, L. 13-16. Contrary to the Companies' claim, these results suggest that considerable risk would be shifted to customers if Rider VBA were approved.

2. The Companies' Alternative to Rider VBA, Rider WNA, Suffers From Many of the Same Deficiencies as Rider VBA and Should Also Be Rejected.

Peoples Gas and North Shore state that preferred Rider VBA is their preferred rider, but submitted Rider WNA as an alternative to deal with the impact of weather on the utilities' respective revenues and earnings. While an improvement over Rider VBA, Rider WNA suffers from some of the same flaws and should be rejected.

The primary problem with Rider WNA is that, like Rider VBA, Rider WNA is designed to protect utility revenues and earnings. As Staff points out, this is fundamentally different from any rider the Commission has approved and that Illinois courts have upheld. Staff Init. Br. at

166. By allowing rates to increase or decrease to meet an established revenue level, Rider WNA violates the rule against retroactive ratemaking. *BPI I*, 136 Ill. 2d at 209.

Further, as also discussed above, Mr. Brosch demonstrated that both Peoples Gas's and North Shore's revenues have remained relatively consistent over the past 11 years. Thus, even if a rider could properly be used to stabilize revenues and earnings, the Companies did not show that their respective revenues have been volatile or have fluctuated widely – prerequisites to rider recovery according to Illinois courts. Approving Rider WNA would also violate the rule against single-issue ratemaking.

Also like Rider VBA, the record shows that, if approved, Rider WNA would cost ratepayers additional money. Staff witness Lazare testified that PGL-NS witness Takle testified that the number of HDDs should rise over the next six to ten years. Staff Ex. 20 (Rev.) at 31, L. 716-18. If Dr. Takle's prediction is correct, then Peoples Gas and North Shore will enjoy additional revenues with Rider WNA in place. *Id*. at 31-32, L. 718-20.

C. Rider ICR

As noted above, the City and CUB take different positions with respect to Rider ICR. As a result, the City and CUB are filing separate reply briefs with respect to this issue.

D. Rider EEP (Merits of Energy Efficiency Programs and Rate Treatment)

1. All Parties Except Staff Support Adoption of PGL-NS's EEP Program. Staff's Arguments Are Not Persuasive and Should Be Rejected.

The City and CUB, PGL-NS, the Environmental Law and Policy Center ("ELPC") and the AG all support adoption of the Companies' proposed Enhanced Efficiency Program ("EEP"). Staff is the lone voice speaking in opposition to the EEP. As we discussed in our Initial Brief (City-CUB Init. Br. at 85-89), Staff's arguments are flawed and should be rejected.

Staff's first claim is that the proposed structure of the EEP does not "guarantee" "prudent expenditures." Staff Init. Br. at 202-03. Staff's argument focuses on the wrong question. The Commission should not ask whether every energy efficiency program that comes out of the EEP will be a perfect program that "guarantees" "prudent expenditures." Rather, the Commission should ask whether it is prudent to establish a program to design and implement energy efficiency programs. There is little doubt that the answer to that question is "yes."

The record shows – and there can be no argument – that gas prices have increased dramatically in the past eight years. ELPC witness Charles Kubert testified that natural gas prices in Illinois averaged $3.00 per thousand cubic feet in 1999. Since 2005, average gas prices have been over $8.00 per thousand cubic feet – an increase nearing 300%. ELPC Ex. 1.0 at 2, L. 40-41.

There can also be little argument that, compared to other states in the Midwest, Illinois has made little investment in energy efficiency. Mr. Kubert presented data showing that

> In 2005, the average residential natural gas consumption in Iowa was 791 therms, in Wisconsin 823 therms, in Minnesota 942 therms. In contrast, the average Peoples Energy residential customer used 1,231 therms and North Shore Gas customer used 1,392 therms. This comparative energy consumption data is attached as Exhibit 1.2. While there are a number of factors driving these differences, including the size and age of the housing stock, it suggests that long-established energy efficiency programs in these neighboring (and colder) states have played a role in reducing gas use. It also suggests that there is significant untapped energy efficiency potential in Illinois.

Id. at 2-3, L. 45-52.

The proposed EEP – although modest in size – can help rectify these issues. Mr. Kubert testified that energy efficiency programs reduce demand, which in turn puts downward pressure on prices. *Id*. at 5, L. 94-96. Mr. Kubert also cited a study conducted by the American Council for an Energy Efficient Economy ("ACEEE") showing that a national one percent decrease in demand for natural gas "could result in wholesale natural gas prices that are 10-20% below a baseline 'business as usual' scenario." *Id* . at 5, L. 98-102. While the proposed EEP cannot produce those results by itself, it is at least provides a contribution – something far more than Staff's "do-nothing" recommendation.

Moreover, the design of the proposed EEP answers Staff's assertion that the program will not necessarily result in prudent expenditures. PGL-NS witness Ilze Rukis described in detail the proposed structure of the EEP. At the top of the EEP will be the Governance Board ("Board"), consisting of five voting members – one each from ELPC, the Companies, a consumer advocacy group, the City and a governmental or consumer organization representing North Shore's service territory. PGL Ex. IR-1.0 at 6, L. 128-35. In addition, the Commission or Staff would have a non-voting member on the Board, facilitating Commission oversight. *Id.* at 6, L. 136-38. The Board will issue Requests for Proposals ("RFPs"), and choose (1) Program Administrator(s), (2) a Contract Administrator and (3) a Program Evaluator. *Id*. at 7, L. 152-56.

The Contract Administrator will provide technical support to the Board regarding program design and performance and assist in drafting the necessary RFPs. *Id*. at 8, L. 163-70. The Program Administrator will design detailed programs in cooperation with the Board and the Contract Administrator and be responsible for delivering the programs and reports to the Board regarding program performance. *Id*. at 8-9, L. 177-85. The Program Evaluator, as the name suggests, will be responsible for auditing the programs that are implemented against defined performance criteria. *Id*. at 9, L. 188-95.

Ms. Rukis testified that the Board can receive periodic reports based on its oversight needs and interests. The topics of such reports could include topics such as cost-benefit analysis, the impact of the programs and environmental and other non-energy benefits. *Id*. at 18, L. 382-93. Ms. Rukis recommends that such periodic reports be provided at least annually. *Id*. at 18, L. 396-96.

In addition to the periodic reports, the EEP will include an independent third-party review. The third party will periodically assess the structure and process of the programs and, if necessary, recommend changes to the Board, the Contract Administrator and the Program Administrator. *Id*. at 10, L. 216-21. Also, within five years of the Commission's approval of the EEP, an independent review will be conducted and provided to the Board for its consideration. Additional independent reviews will be conducted no sooner than three years and no later than five years after the first review. *Id*. at 10-11, L. 221-32. All of these reports would be available to the Commission through its participation on the Board.

Moreover, as Ms. Rukis testified during cross-examination, the Commission would maintain authority over the EEP. The Commission has authority over the Companies' respective rates. Sep. 10, 2007 Tr. at 104. In to reports provided to the Board, the Commission would have the ability to review the on-going progress of the EEP. *Id*.

In sum, the record shows that it is prudent for the Commission to approve an energy efficiency program. Illinois lags behind other Midwest states in this respect. Also, energy efficiency programs can put downward pressure on gas prices. In addition, the structure of the proposed EEP and the safeguards in place make it likely that the funds invested by the Board will be prudently spent.

Staff's next complaint concerns Dr. Rearden's assertion that the EEP should be rejected because not all ratepayers will be able to participate in energy efficiency programs under the EEP, yet all customers will pay into the program. Staff Init. Br. at 203-04. Staff's facile argument is not persuasive. As we mentioned in our Initial Brief (at 85), Staff's assertion ignores the fact that many utility expenditures are made for a small subset of customers, yet all customers pay for such costs. For example, when a new home is connected to the system or the distribution system is expanded to serve additional demand, all customers pay for such costs while the new customer and the customers creating the additional demand are the ones who mostly benefit from the expenditures. *See, e.g.*, ELPC Ex. 2.0 at 4, L. 52-54. Moreover, as noted earlier, energy efficiency programs reduce demand on the system. Reduced demand can lead to lower prices. Indeed, the ACEEE study cited by Mr. Kubert concluded that a national 1% decrease in demand could lead to a 10-20% reduction in prices compared to a baseline "business as usual" scenario." ELPC Ex. 1.0 at 5, L. 98-102.

Next, Staff claims that the EEP is inefficient because high gas prices are sufficient to cause persons to invest in energy efficiency. Staff Init. Br. at 204. Staff's argument assumes a perfect market and that people have all the information and resources necessary to invest in energy efficiency programs that are in their economic self-interest. Of course, no such perfect world exists, as even Staff's expert admitted. Dr. Rearden conceded that some customers may not implement energy efficiency or conservation measures because they lack the requisite information that it is in their best interest to do so. Sep. 11, 2007 Tr. at 708-09. Dr. Rearden also admitted that "there is, at the very least, a subset of Peoples Gas and North Shore ratepayers out there who could use financial assistance in helping them make rational energy efficiency investments." *Id*. at 723-24. Dr. Rearden added that some consumers may have sufficient funds to pay their monthly gas bills, but lack the necessary funds to make a larger outlay for energy efficiency measures even if it is in their self-interest to do so. *Id*. Although it may be true, as Staff claims, that there may be incentives paid for investments in projects that would have been made even absent such incentives, Staff's argument lets the perfect be the enemy of the good.

Finally, Staff claims that it has concerns about the governance of the program. Staff Init. Br. at 206-07. In particular, Staff claims that the lines of command are not clear. *Id*. The basis for Staff's confusion is not clear. The EEP's design and structure is described above and in more detail in Ms. Rukis's Direct Testimony. *See e.g.*, PGL Ex. IR-1.0 at 5- 1, L. 109-232; PGL Ex. IR-1.1. The attachment to Ms. Rukis's Direct Testimony shows that the Governance Board is ultimately responsible for the design and implementation of the EEP. Staff's concern is not well-founded.

Staff also argues that the organization be one that is "accountable and efficient" and not burdened with undue administrative expenses. Staff Init Br. at 206-07. The City and CUB agree with these points. If the Commission feels that the proposed organizational structure is problematic, we look forward to working with the Commission to resolve such issues.

In sum, Staff's concerns about the EEP are unfounded. The EEP represents a good first step in permitting Illinois to achieve the benefits of natural gas energy efficiency programs that other Midwest states have enjoyed. Admittedly, taken alone, the EEP may not be able to decrease prices in Chicago. However, the EEP, in conjunction with other programs implemented as local and national interest in energy efficiency grows, can have an effect on demand, and, therefore, prices. The problems the EEP addresses will not be solved by any single initiative, but this proposal is one that can incrementally advance the effort.

2. *Rider EEP Fails to Meet the Criteria for Rider Recovery and, Therefore, Should Be Rejected.*

As noted in our Initial Brief, Rider EEP is perhaps least likely to past legal muster because the *Finkl* case is directly on point. In *Finkl*, the court reviewed a Commission order approving ComEd's proposed Rider 22, which allowed ComEd to recover the costs of demand side management programs (*i.e.*, energy efficiency programs) through a rider. *Finkl*, 250 Ill. App. 3d at 322. The court reversed the Commission's on numerous grounds. Among other problems, the court stated that the types of costs that could be recovered through Rider 22 "reveal no greater potential for unexpected, volatile or fluctuating expenses which Edison cannot control, than costs incurred in estimating base ratemaking." *Id*. at 327. The court added that any uncertainty in determining demand side management costs could be addressed through the traditional bas rate setting process. *Id*. The court also found that because Rider 22 allowed ComEd to recover its energy efficiency costs in isolation – that is, outside the context of a traditional rate case where all utility costs and revenues are considered – the Commission's order also violated the rule against single-issue ratemaking. *Id*. at 326-27.

In defending Rider EEP, the Companies assiduously avoid mentioning the *Finkl* case. Instead, the Companies offer two reasons why Rider EEP should be approved. First, the utilities assert that Peoples Gas previously recovered energy efficiency costs through its Rider 16. PGL-NS Init. Br. at 133. The Companies neglect to mention whether that rider pre-dated the *Finkl* decision and why the *Finkl* decision is not dispositive.

Next, the utilities state that "legislation has been offered that has been offered that may lead to a statewide energy efficiency initiative. The Companies add that if they fund programs pursuant to the statewide initiative, they would not want to burden their customers with funding multiple programs. *Id*. The Companies' argument is not persuasive in that, as it concedes, the legislation referenced is only proposed, it has not been enacted. Moreover, its unclear how the proposed legislation avoids the *Finkl* court's holding that energy efficiency programs are not appropriate for rider recovery.

E. Rider UBA

Rider UBA is the Companies' proposal to recover gas cost-related bad debt through a rider. Peoples Gas and North Shore present essentially two arguments in support of special rider treatment for these costs. Neither argument is persuasive and the proposed rider should be rejected.

First, Peoples Gas and North Shore claim that uncollectible costs are volatile and beyond the Companies' control. PGL-NS Init. Br. at 137. The record does not support that assertion. Staff witness Lazare testified that uncollectible costs (including both gas costs and non-gas costs) were fairly steady around $20 million per year from 1996 through 2000. Staff Ex. 8.0 at 23, L. 529-30. Between 2001 through 2003, uncollectible costs increased to approximately $40 million per year. *Id*. at 23, L. 530-31. Since that time, uncollectible expenses have leveled off at around $35 million per year. *Id*. at 23, L. 531-32.

The story for North Shore is similar. Uncollectible expenses (including both gas costs and non-gas costs) were stable prior to 2001. Uncollectible expenses spiked as gas prices spiked in 2001. Since that time, uncollectible expenses have stabilized as gas prices have stabilized.

Staff Ex. 8.0 at 24, L. 537-42; *see also* GCI Ex. 1.0 at 67, L. 21-22.

The jump in uncollectible costs from 2000 forward is easily explainable as gas costs increased dramatically beginning in 2001 and into 2002. Staff Ex. 20.0 (Rev.) at 6, L. 117-20. Since that time, gas prices have moderated – although at price levels higher than prior to 2001 – and, as a result, so has the variability in uncollectible expenses. *Id*. at 6, L. 120-21; *see also* GCI Ex. 1.0 at 67, L. 21-22.

The inescapable conclusion is that uncollectible costs are not nearly as volatile as the Companies portray. Moreover, as Staff points out in its Initial Brief, if uncollectible costs – and the many other costs that the utilities are seeking to recover through riders in this case – were such a drain on the Companies' finances, there was nothing preventing them from filing rate cases less than 12 years apart. Staff Init. Br. at 215. Had they done so, perhaps the traditional ratemaking process (given the opportunity) would have resolved some of the business issues the Companies claim threaten their financial integrity now.

Because uncollectible costs are not volatile, they are not appropriate for rider treatment. If approved, Rider UBA would violate the rule against single-issue ratemaking.

The Companies' second argument is that several states have adopted Rider UBA-type mechanisms. PGL-NS Init. Br. at 140. Again, the record betrays the Companies' argument. The utilities rely on a Citigroup Research report to support their assertion that there is a trend of regulatory commissions adopting Rider UBA-like riders. PGL Ex. RAF-1.0 at 38-39, L. 755-68; NS Ex. RAF 1.0 at 35-36, L. 766-79. However, the Citigroup Research report describes the adoption of uncollectible trackers as discouraging. Staff Ex. 8.0 at 23, L. 512-15. Also, as Staff points out in its brief, the Citigroup Research report identified only 13 utilities with uncollectible riders. Staff Init. Br. at 217. This is hardly an overwhelming number, as Illinois itself has eight major public utilities.

Finally, and perhaps most importantly, the Commission rejected a similar proposal in Nicor's most recent rate case. In rejecting NICOR's proposed rider, the Commission stated

> The Commission agrees with CUB/CCSAO's analysis that Nicor's proposed "uncollectible expense tracker" should not be utilized. Commodity-related uncollectibles expense should not be split from other uncollectibles expense. The Commission agrees with Staff and CUB/CCSAO that costs, such as uncollectibles, which are a normal cost of the provision of service, do not warrant special recovery through a rider. Nicor has not met its burden of showing that these costs are of a nature that should be recovered through a rider rather than through base rates. The gas cost portion of Nicor's uncollectibles is presently being recovered through base rates, and should continue to be recovered through base rates.

ICC Docket No. 04-0779, Order at 181 (Sep. 9, 2005). Peoples Gas and North Shore have presented no reason why the Commission should deviate from its decision in the Nicor case.

* * * * *

In sum, Peoples Gas and North Shore have failed to meet their burden to show that Rider VBA, its proposed alternative Rider WNA, Rider EEP and Rider UBA should be adopted. The Companies failed to show that the proposed riders would recover costs that are volatile, fluctuate and are beyond the control of the utilities – the legal standards adopted by Illinois courts for costs that are appropriate for rider recovery. Because the riders fail to meet the criteria for rider recovery, adopting them would violate the prohibition against single-issue ratemaking.

Moreover, Rider VBA and Rider WNA would not recover specific, identified costs at all. Instead, the riders are designed to protect the Companies' revenues and earnings. Because

Riders VBA and WNA would adjust rates up and down to collect a pre-determined level of revenues, these riders would violate the rule against retroactive ratemaking.

These deficiencies and others require that the Commission reject Rider VBA, its proposed alternative Rider WNA, Rider EEP and Rider UBA.

VIII. COST OF SERVICE

B. Embedded Cost of Service Study

2. Contested Issues

a. Coincident Peak Versus Average and Peak Allocation Methods

The Companies presented three embedded cost of service studies in this case, each using a different method for allocating demand-related costs: the Coincident Peak ("CP") method, the Average and Peak ("A&P") method, and an alternative CP method that classifies a portion of distribution mains as customer-related. As discussed in Staff's and City-CUB's respective initial briefs, the utilities' preferred method – the unmodified CP method – is inconsistent with the longstanding Commission policy of using the A&P method in natural gas utility rate cases and with the operation of the Companies' system. *See* Staff Init. Br. at 227-30; City-CUB Init. Br. at 92-97. Because nothing in the Companies' Initial Brief warrants a different treatment, the Commission should reject the Companies' proposal to use the CP method and continue to apply the A&P method for allocating distribution demand-related costs.

In their Initial Brief, the Companies contend that Staff and City-CUB have not adequately explained why the Commission should adopt the A&P method. PGL-NS Init. Br. at 144. This contention is entirely without merit and should be rejected. As an initial matter, this claim rests on a reversal of the statutory burden of proof, which rests entirely on the utilities. *See* 220 ILCS

5/9-201(c). The Companies alone bore the burden of demonstrating that their proposed allocation method is just and reasonable – a burden that, as Staff and City-CUB have shown, the utilities have failed to meet with respect to their proposed cost allocation method.

As City-CUB and Staff made clear in their Initial Briefs, the utilities have offered no sound reason for deviating from the Commission's policy of applying the A&P method, which has been employed in "virtually every [ICC] natural gas delivery service rate case in the past ten years." City-CUB Ex. 1.0 at 74, L. 1792-94; *see also* City-CUB Init. Br. at 93-94; Staff Init. Br. at 229-30. As Staff witness Mike Luth observed, the Commission concluded in Nicor's most recent rate case (ICC Docket No. 04-0779) that not all costs of the natural gas distribution system "are directly related to peak demand," and the A&P method, therefore, is a more appropriate means of allocating demand-related costs. Staff Ex. 7.0 at 13, L. 238-41. That principle applies equally to the Companies. In fact, NS/PGL witness Ronald Amen proposed the preferred allocation method of the Companies despite his acknowledgment that the Commission adopted the A&P methodology in the Companies' last rate cases. PGL Ex. RJA-1.0 at 17, L. 376-77; NS Ex. RJA-1.0 at 17, L. 379-80.

In addition, the Companies have not shown that the CP allocation method reflects actual cost causation on their system. *See* City-CUB Init. Br. at 94-97. Although the Companies continue to insist that demand-related costs are incurred entirely to meet peak demands, *see, e.g.*, NS-PGL Init. Br. at 143-44, their assertion was contradicted at the evidentiary hearing. Specifically, the Companies' Vice-President for Gas Operations, Edward Doerk, candidly acknowledged under cross-examination that (1) the Companies do not always immediately construct new facilities to meet increased customer demand that exceeds existing capacity, and

(2) the Companies' system capacity design decisions are based on both the demands of customers at the system peak and the load supplied to customers over periods more inclusive than just the system peak. *See* Sep. 10, 2007 Tr. at 210-14; *see also* City-CUB Init. Br. at 94-97. Thus, the utilities' proposal to allocate distribution costs based solely on peak demand does not reflect the realities of the Companies' distribution operations.

The Companies have not met their burden to demonstrate that their preferred CP allocation method is just and reasonable. Nevertheless, the utilities assert in their Initial Brief that (a) CUB-City witness Chris Thomas has not explained how use of the A&P methodology "relates to how the utility systems were built"; (b) how a distribution system designed "only to accommodate average gas demands" could meet peak system demands; and (c) why recognizing system utilization "addresses the principle of cost causation." PGL-NS Init. Br. at 144. As shown below, none of these contentions has merit.

With respect both to the relationship between the A&P method and expansion of the utilities' systems as well as cost causation, Mr. Thomas plainly explained why the costs of the utilities' distribution facilities are not only a function of capacity, but also of usage. Specifically, Mr. Thomas stated that

> [w]hile customers do expect the system to be of sufficient size or functional capacity to accommodate their needs, they also rely on it to be available every time they desire gas. Both requirements are necessities for adequate and reliable service from the gas system, and thus both drive system costs. I believe it is much more accurate to say that the system is designed and installed to meet year-round demand, but should be sized to meet peak demand. This is the relationship accounted for by using the A&P allocation factor, as Mr. Luth and I have recommended.

CUB-City Ex. 2.0 at 28, L. 634-40; *see also* Staff Ex. 19.0 at 6-7, L. 120-29 ("[T]here are costs associated with putting a distribution system in place and operating the system, regardless of capacity, that are not affected by a change in capacity."). Thus, Mr. Thomas and Mr. Luth have made clear that the A&P method properly reflects that the utilities' system is built – and the associated costs incurred – to serve average as well as peak demands.

Similarly, no weight should be given to the Companies' misleading suggestion that the A&P method assumes that the utilities' distribution system was built entirely to meet average demand. No party disputes that the system must be able to meet peak demand. But that principle does not affect the propriety of using the A&P methodology to allocate demand-related costs. As the Companies well know, the A&P method takes into account both average *and* peak demand in allocating distribution-related costs. *See, e.g.*, PGL Ex. RJA-1.0 at 15, L. 328-30 (noting that the A&P methodology "often gives equivalent weight to peak demands and average demands"). In fact, Mr. Luth maintained that the "most signficant factor in A&P is . . . peak demand because it represents approximately 3/4 of the allocation." Staff Ex. 19.0 at 6, L. 114-16. Unlike the CP methodology, the A&P methodology, therefore, takes into account the relationship between investment in the distribution system and both kinds of demand that the Companies are obliged to meet.

The Companies' proposed CP allocation is inconsistent with the Commission's settled policy of applying the A&P method to allocate distribution costs, is premised on the discredited assertion that the utilities' distribution plant investments are incurred solely to meet peak demands and does not reflect operational reality. The Companies have offered no convincing reason to depart in this case from the Commission's established practice. Accordingly, the

Commission should reject the Companies' proposed CP allocation methodology and continue to apply the A&P method in allocating demand-related costs.

c. Allocation of Costs to S.C. No. 1H and S.C. No. 1N

The Companies's proposal to bifurcate S.C. 1 (Small Residential) into heating (1H) and non-heating (1N) service classifications is based on a purported difference in the cost of serving S.C. 1 heating and non-heating customers and the assertion that bifurcation would mitigate the alleged subsidy of non-heating customers by heating customers. *See* PGL Ex. VG-1.0 (2Rev.) at 11, L. 230-36; NS Ex. VG-1.0 (3Rev.) at 9, L. 193-99; PGL-NS Init. Br. at 146. Because the Companies have failed to show that bifurcation is warranted on either ground, S.C. 1 should remain as a single class.

In their Initial Brief, the Companies contend that GCI witness William Glahn's conclusion that the utilities' bifurcation proposal is based on an "artificial cost of service disparity" (GCI Ex. 3.0 (Rev.) at 17, L. 11-14) has "no bearing on whether bifurcation is appropriate." PGL-NS Init. Br. at 147. This conclusory statement is belied by the Companies' emphatic insistence that there is a "significant difference" in the cost of serving S.C. 1 heating and non-heating customers. *Id.* at 146; *see also* PGL Ex. VG 1.0 (2Rev.) at 11, L. 242-44; NS Ex. VG-1.0 (3Rev.) at 10, L. 202-04. Given that the Companies rely on this purported cost differential as the primary basis for their bifurcation proposal, whether any such difference is as significant as the Companies claim is a relevant and, in fact, core issue relating to whether bifurcation is warranted.

In the testimony cited by the Companies, Mr. Glahn explained that, according to the Companies' own workpaper (*see* GCI Ex. 3.2, Schedule 3), the per-unit cost of regulators for non-heating customers is less than a third of the cost for heating customers, and that the per-unit cost of services for non-heating customers is approximately one-third the cost for heating customers. GCI Ex. 3.0 (Rev.) at 16-17. Mr. Glahn added that this alleged difference seems implausible because the cost of installing services presumably would depend largely on labor and construction costs that "should vary little by the size of the pipe, at the sizes typically used for residential customers." *Id.* at 17, L. 4-7. Additionally, Mr. Glahn questioned whether the utility would dig up an old service and replace it with a larger one every time a non-heating customer decides to install a gas furnace and become a heating customer, or instead simply install from the beginning services that would accommodate a range of end uses. *Id.* at 7-11; *see also* Sep. 10, 2007 Tr. at 210-11 (Mr. Doerk: "[o]n a case-by-case basis . . . it is possible" that a residential customer could double consumption without requiring a larger service pipe). In any event, the Companies have not satisfactorily explained, either in testimony or their Initial Brief, why there is ostensibly such a large disparity in the cost of services for heating and non-heating customers in S.C. 1.

Responding to these observations, the Companies' Initial Brief recites testimony that adds further confusion rather than clarification, reinforcing Mr. Glahn's point that the utilities' bifurcation proposal is premised on an artificial cost of service disparity. *See* PGL-NS Init. Br. at 147-48. In particular, Mr. Amen maintained that the magnitude of the asserted cost difference is attributable to the "occurrence of multiple S.C. No. 1 non-heating customers served by shared gas lines" and the fact that nearly half of Peoples Gas's residential heating customers are served by a separate service line. PGL-NS Ex. RJA-2.0 at 15, L. 327-36; PGL-NS Init. Br. at 147. Yet, in hearing testimony that the Companies' Initial Brief fails to mention, Ms. Grace stated that S.C.

No. 1 includes only dwellings with two or fewer units. Sep. 12, 2007 Tr. at 959. If this is the case, Mr. Amen's explanation for the cost of service differential between S.C. 1 heating and non-heating customers is implausible. It seems highly unlikely that service costs vary significantly – by a 3-to-1 ratio, as calculated by Mr. Glahn – according to whether the service is used by one customer or is shared by two customers. In fact, Mr. Amen testified on cross-examination that a "relatively prevalent practice" in the gas distribution industry is to have two single-family dwellings share a single service. In such cases, Mr. Amen added, "the service line has enough capacity, generally speaking, that it doesn't require a larger service than it otherwise would to service a single customer," depending on the pressure system to which the service is connected. Sep. 10, 2007 Tr. at 321. And Ms. Grace claimed that "[c]ertain non-heating customers may consume larger quantities [of gas] than heating customers in a given month due to personal preferences such as cooking, water heating or clothes drying as well as the efficiency of appliances used for such activities." NS/PGL Ex. VG-3.0 (Rev.) at 8, L. 165-67. Tellingly, ECOSS results notwithstanding, the Companies have never asserted that larger services must be installed to serve such non-heating customers even though their loads may exceed those of heating customers. Nor is it clear whether the Companies' claim that "[a]s a group, heating customers place a significantly higher peak load on the system than do non-heating customers" refers to all heating and non-heating customers or just heating and non-heating customers in S.C. 1. PGL-NS Init. Br. at 148.

Apparently, the Companies expect the Commission to approve the bifurcation of S.C. 1 into heating and non-heating sub-classes based on a questionable cost of service differential that may or may not apply to heating and non-heating customers *in S.C. 1*. The Companies have failed to carry their burden to demonstrate that the ostensibly significant difference in the cost to serve S.C. 1 customers is due to a heating/non-heating distinction rather than the single/multiple family factor Mr. Glahn identified. The utilities' Initial Brief does not cure these deficiencies, which are fatal to their bifurcation proposal.

City-CUB's response to the Companies' argument that bifurcation and the proposed customer charges for S.C. 1 heating and non-heating customers would not harm low-income customers is set forth in section IX.C.2.a. below. As to the Companies' contention that S.C. 1H customers would pay lower rates under bifurcation than under Mr. Glahn's recommended rates (*see* PGL-NS Init. Br. at 148), this claim fails to consider the potentially significant impact on such customers' usage of energy efficiency programs, particularly those targeted at low-income customers. *See* GCI Ex. 6.0 (Rev.) at 13, L. 301-06.

Finally, the Companies have not demonstrated that bifurcation would mitigate any subsidy running between heating customers and non-heating customers. The Companies appear to agree that to the extent there currently is an intra-class subsidy within S.C. 1, it is from heating to non-heating customers.[10] PGL-NS Init. Br. at 148-49; GCI Ex. 3.0 (Rev.) at 22-23. This conclusion is based on Peoples Gas's class revenue/embedded cost comparison (PGL Ex. VG-1.3, p.2), which shows that at current rates, non-heating customers pay 62.55 percent of their proposed cost of service, while heating customers pay 70.93 percent of their proposed cost of service – a gap of 8.38 percent. GCI Ex. 3.0 (Rev.) at 22-23. Although the Companies' proposed rate increase allocation would move both groups closer to their respective costs of

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[10] In fact, as the following discussion shows, there is likely no subsidy flow within the residential class. Neither heating nor non-heating customers cover their own costs, much less those of another customer subgroup. Thus, the Companies' emphasis on reducing a subsidy deserves no weight in the Commission's deliberations.

service, that allocation would narrow the gap in the percentages of cost of service paid by S.C. 1N and 1H customers by a negligible amount – from 8.38 percent to 8.3 percent. Thus, to the extent heating customers are subsidizing non-heating customers under current rates (when compared with each sub-class's proposed cost of service), bifurcation would not eliminate or meaningfully reduce that subsidy – one of the Companies' stated goals in proposing bifurcation. *See* PGL Ex. VG-1.0 (2Rev.) at 11, L. 232-37; NS Ex. VG-1.0 (3Rev.) at 9, L. 191-97. Thus, there is no merit to the Companies' bald assertion that Mr. Glahn's conclusion that bifurcation would not materially affect the alleged intra-class subsidy within S.C. 1 "proves nothing" with respect to the appropriateness of bifurcation. PGL-NS Init. Br. at 149. In fact, it is the utilities' claim that bifurcation "does not result in higher rate increases for heating customers" (*id.*) that is irrelevant to the merits of bifurcation.

The Companies have failed to meet their burden to show that bifurcation of S.C. 1 is warranted. The evidence of record establishes neither that the alleged disparity in the cost of serving S.C. 1 heating and non-heating customers is significant nor that bifurcation would mitigate any intra-class subsidy within S.C. 1. Accordingly, the Companies' bifurcation proposal should be rejected and S.C. 1 maintained as a single class.

d. Allocation of Distribution Plant Account No. 385

The ECOSS assigns costs recorded in FERC Account No. 385 – Industrial Metering and Regulating Station Equipment to Service Classifications ("S.C.") 2 and 4. As set forth in City-CUB's Initial Brief, however, such costs can and should be charged to individual customers rather than the entire service classifications to which those customers belong. *See* City-CUB Init. Br. at 98-101. The Companies' Initial Brief does not show otherwise.

In particular, it is undisputed that: (a) the Companies can track FERC Account No. 385 costs to individual customers; (b) customers that cause the Companies to incur costs recorded in Account No. 385 may migrate from one rate classification to another; and (c) the number of such customers is small. NS/PGL Ex. RJA-2.0 at 17-18, L. 376-87; *see also* Sep. 10, 2007 Tr. at 324-25. Accordingly, the GCI recommend that the Companies impose a special "facilities charge" or "metering surcharge" on the individual customers causing the costs in Account No. 385, regardless of the rate classifications to which the customers belong. *See* City-CUB Init. Br. at 98. Direct assignment to individual customers would ensure that the Companies recover Account No. 385 costs entirely from the actual cost causers – not the cost causers as well as other non-cost causers who happen to be in the same customer class as the cost causers.

The Companies' contention in their Initial Brief that direct assignment of such costs to individual customers would be "impractical and inappropriate" does not undermine Mr. Glahn's recommendation. PGL-NS Init. Br. at 150. Specifically, the Companies' argument that direct assignment of Account 385 costs would have a *de minimis* impact on S.C. 2 customer charges (NS/PGL Init. Br. at 150) rests on a mischaracterization of their own witness's testimony. Specifically, Mr. Amen identified an electric power plant in S.C. 2 responsible for "over one-third of the costs recorded in Account No. 385," NS/PGL Ex. RJA-2.0 at 17-18, L. 382-87, and, in the calculations to which the Companies' Initial Brief refers, showed the impact on S.C. 2 rates of directly assigning Account 385 costs attributable to that power plant – not, as the Companies contend in their brief, *all* of the costs recorded in Account No. 385. *See* NS/PGL Ex. 3.0 at 11, L. 242-45. Even assuming *arguendo* that the Companies were correct that directly assigning all costs in Account 385 would have a minimal impact on S.C. 2 rates, the cost impact of following sound cost allocation principles is not a basis for ignoring them. Here, the applicable principle is that costs that can be directly assigned to particular customers should be so assigned – an approach that, according to Mr. Amen, cost analysts "seek[ ] to maximize" to the extent possible. PGL Ex. RJA-1.0 at 12, L. 261. Similarly, the Companies' assertion that direct assignment of Account No. 385 investments raises the question of whether other customer-specific costs should be directly assigned to individual customers (PGL-NS Init. Br. at 150-51) does not defeat the reasons that Account No. 385 can and should be assigned to the customers causing such costs. Other customer-specific costs – which may not be as highly specialized and unique to individual customers as Account 385 costs – are not at issue here.

The Companies have offered no sound reason for refusing, with respect to Account No. 385 plant, to implement their practice of directly assigning costs to the cost causers. Because Account No. 385 costs can be tracked to particular customers, such costs should be charged to those customers – and only those customers.

e. Differentiated Class Rates of Return

The Companies' ECOSS allocates revenue responsibility at equalized class rates of return. NS/PGL Init. Br. at 151. Thus, the ECOSS is premised on the assumption that each customer class contributes the same level of risk to the Companies' overall risk profile. City-CUB Ex. 2.0 (Public) at 29, L. 651-53. As City-CUB witness Thomas testified, this assumption is unsupported.

In fact, as Mr. Thomas explained, there is ample reason to conclude that the relative risk of serving customers varies by customer class. In particular,

> [c]ommercial and residential customers use gas very differently, and their usage is affected by different factors. For example,

> residential usage tends to vary with weather, while commercial and industrial usage tends to vary with general economic conditions. This means that there are very different risk factors related to the revenue the Companies receive from each customer class.

City-CUB Ex. 1.0 at 77, L. 1870-74.

Rather than address these considerations in their Initial Brief, the Companies merely intone that no evidence has been presented suggesting that the notion of risk-adjusted class rates of return is appropriate "for consideration in this instant case." PGL-NS Init. Br. at 151-52. This assertion reverses the statutory allocation of the burden of proof; the utilities alone – not Staff or intervenors – bear the burden of proof to establish that their proposals are just and reasonable. 220 ILCS 5/9-201(c). To demonstrate that the Companies have failed to meet their statutory burden with respect to their proposed revenue allocation, City-CUB need not adduce evidence disproving the Companies' *assumption* that the risk that the Companies will not recover the costs of service does not vary by customer class. Rather, it is sufficient to point out – as Mr. Thomas did – that there is "absolutely no evidence" supporting their assumption. City-CUB Ex. 2.0 at 29, L. 651-52.

The Companies also attempt to discredit Mr. Thomas's testimony by noting that Mr. Thomas did not propose that the ECOSS be adjusted to reflect class-specific rates of return. NS/PGL Init. Br. at 151. This fact, however, has no bearing on Mr. Thomas's essential point: the utilities' apparent reliance on speculation in allocating their revenue requirement is a stark reminder that the ECOSS is not an infallible, purely objective basis for apportioning revenues among the customer classes. As Mr. Thomas explained, the ECOSS can be a useful starting point – albeit not the conclusive basis – for setting just and reasonable rates and charges. City-CUB Ex. 1.0 at 78, L. 1883-94. But to the extent the ECOSS is used for that purpose, the

Commission should ensure that the study attributes costs to each customer class as accurately as possible. *See* City-CUB Ex. 1.0 at 78, L. 1891-94.

f. Allocation of Revenue Requirement to Customer Classes

Asserting – incorrectly – that Mr. Thomas offered no alternative approach to allocating the Companies' revenue requirement among the service classifications, the Companies criticize Mr. Thomas's testimony cautioning the Commission against relying exclusively on the Companies' ECOSS in designing rates for customers. *See* PGL-NS Init. Br. at 152 (citing CUB-City Ex. 1.0 at 72, L. 1742-45). Nonetheless, the Companies acknowledge that they do not believe cost of service to be the only consideration "relevant to the revenue allocation process." *Id.* And that Mr. Thomas did not propose alternatives to every aspect of the Companies' revenue allocations does not, as the Companies maintain, make the ECOSS "the most reasonable basis for establishing cost responsibility among the customer classes." *Id.* The Companies cannot meet their burden of proof by claiming that other parties have not proposed reasonable alternatives. Rather, the PUA requires them to affirmatively establish that their proposals are just and reasonable. The Companies' failure to meet this burden establishes that the utilities' specific cost and revenue allocation proposals addressed in this section and section IX below must be rejected.

IX. RATE DESIGN

A. Overview

In his Direct Testimony, GCI witness Glahn identified 10 established objectives of rate design, as described by the American Gas Association ("AGA"):

- Achieving the revenue requirement;
- Economic efficiency;
- Fairness or equity;
- Simplicity and administrative ease;
- Conservation of resources;
- Stability and gradualism;
- Social goals;
- Environmental protection;
- Employment; and
- Balance of payments.

GCI Ex. 3.0 (Rev.) at 7, L. 5-15. In addition to these principles, Mr. Glahn noted, Dr. Bonbright has identified a number of attributes of a "sound rate structure," the sixth of which is to attain equity in three dimensions: "(1) *horizontal* (i.e., equals treat ed equally); (2) *vertical* (i.e., unequals treated unequally); and (3) *anonymous* (i.e., no ratepayer's demands can be diverted away un-economically from an incumbent by a potential entrant." *Id.* at 7, L. 20-28 (quoting Bonbright, et al., *Principles of Public Utilities Rates* 383-84 (2d Ed.1988) (emphases in original)).

In their Initial Brief, the Companies identify a distinct set of rate design objectives that they seek to achieve in this case. Five of those six objectives are relevant here: (1) better align costs and revenue recovery; (2) provide more equity between and within rate classes; (3) maintain rate design continuity; (4) reflect gradualism; and (5) retain customers on the system. PGL-NS Init. Br. at 153.

As discussed in City-CUB's Initial Brief, *see* City-CUB Init. Br. at 103-04, the Companies' list of rate design objectives omits several of the objectives identified by the AGA: economic efficiency, fairness, simplicity and administrative ease, conservation of resources, social goals, environmental protection, employment and balance of payment considerations. *See Id.* In reviewing the Companies' rate design proposals, the Commission should consider all of the objectives identified by the AGA – including those public policy concerns that the Companies omitted – as well as Dr. Bonbright's equity principles.

B. General Rate Design

1. Allocation of Rate Increase

To move the utility's classes closer to cost of service, Peoples Gas proposes moving its S.C. Nos. 4, 6 and 8 to cost, and then apportioning the remaining portion of the proposed revenue requirement – $72.9 million, for Peoples Gas – among S.C. Nos. 1N, 1H and 2 using the Equal Percentage of Embedded Cost ("EPEC") method. The EPEC method allocates the increase portion of the proposed revenue requirement based on the class's proportion of embedded costs to total embedded costs. PGL Ex. VG-1.0 (Rev.) at 6, L. 123-30. Peoples Gas maintains that this approach "provides a gradual movement" toward equal class rates of return. NS-PGL Init. Br. at 159. Although gradualism is a crucial rate design objective, the Companies' proposed allocation of the Peoples Gas rate increase nonetheless should be adjusted as recommended by the GCI to more equitably apportion the increase. *See* City-CUB Init. Br. at 105-09.

In particular, the Companies' allocation proposal violates the principle of horizontal equity – that is, that equals should be treated equally – by treating Peoples Gas's business classifications differently. Peoples Gas's failure to follow that principle results in an increase of almost 22 percent in rates for its S.C. No. 2 customers but only a 14 percent increase for S.C. 3 customers and just a 2.12 percent increase for S.C. 4 customers. GCI Ex. 3.0 (Rev.) at 12-13. As Mr. Glahn explained, this inequitable allocation results from the Companies' arbitrary grouping of S.C. 1 and 2, S.C. 3 and 4; and S.C. 6, 7 and 8 for purposes of allocating PGL's proposed rate increase. *Id.* at 13, L. 20-23.

The Companies have yet to explain the reasons for so grouping the service classifications. *See* City-CUB Init. Br. at 105-06. Therefore, it remains unclear why, in apportioning its proposed rate increase, Peoples Gas grouped S.C. 2, the general service class, with S.C. 1N and 1H, both small residential classes, rather than with S.C. 3 and 4. Although to justify this grouping, Ms. Grace pointed to differences in average annual loads and rate structures of S.C. 2 and 4 (*see* NS/PGL Ex. VG-3.0 at 6-7, L. 126-37), she did not compare the respective differences between S.C. 2 and S.C. 4 on the one hand, and between S.C. 2 and S.C. 1N and 1H on the other. The Companies, therefore, have not shown that S.C. No. 2 is more similar in terms of annual load to S.C. Nos. 1N and 1H than to the combined S.C. No. 4, and therefore should be grouped with S.C. 1 rather than S.C. 4.

Peoples Gas's allocation of its proposed rate increase also is inequitable because it recovers none of the increase from S.C. 7 – even though that class is grouped with S.C. 6 and 8. Peoples Gas asserts this omission is appropriate because "the revenues from customers served under this service classification are based on a negotiated [contract] rate rather than the cost of service analysis filed in this case." PGL Ex. VG-1.0 (3Rev.) at 8 L. 161-63. Regardless of how prices are determined for members of Service Classification No. 7, there is a cost to serve these customers. By excluding S.C. 7 from the EPEC exercise, Peoples Gas assumes that the cost to serve this group of customers has not increased since 1995, while the cost to serve all other customers has increased more than 27 percent. *See* City-CUB Init. Br. at 107.

The Companies counter that the contracts for customers served under S.C. 7 are limited to five-year terms, have been renegotiated "based on the proper cost considerations" and cannot be modified to include an appropriate portion of the proposed rate increase. PGL-NS Init. Br. at 176. This response lacks any apparent support in the record; none is cited, as the Commission's rules require. 83 Ill. Adm. Code §200.800(a). Moreover, it does not rebut – let alone address – GCI's fundamental argument: S.C. No. 7 customers use the same system facilities and services as customers in other service classifications, and the cost of building, operating and maintaining those facilities and services has risen since Peoples Gas's last rate case.[11] *See* GCI Ex. 6.0 (Rev.) at 8-9, L. 202-06. The utility's vague reference to purportedly "proper cost considerations" (PGL-NS Init. Br. at 176) – which the Companies have not disclosed – is based on facts not in the record of this case and, therefore, must be disregarded. Even taking the Companies' assurances seriously, they should not distract the Commission from the uncontested fact that Peoples Gas allocated none of its proposed rate increase to S.C. 7, thereby removing S.C. 7 customers from the ratemaking process and any regulatory review of their rates. That is both unwise and unlawful.

As to how, as a practical matter, a portion of the rate increase could be recovered from S.C. No. 7, Peoples Gas has not stated whether their contracts with S.C. 7 customers include a provision incorporating Commission-approved changes in the Companies' rates – and if not, why they do not. To the extent the contracts do not include such a provision, that omission should not

[11] This response is even more troubling considering that Peoples Gas proposes to double (to ten years) the maximum permissible length of its contracts with S.C. 7 customers. *See* Staff Init. Br. at 239. Doubling the allowed contract period would only exacerbate the cost shifting inherent in exempting S.C. 7 customers from any responsibility for increased costs.

serve as a basis for shifting S.C. 7 cost increases to other customer classes through the allocation process. Indeed, if those additional costs are not recovered from S.C. 7 customers, the Commission should order that revenues foregone from exempting such customers from responsibility for increased costs cannot be shifted to other service classifications. If Peoples Gas is ordered to recover those additional costs from S.C. No. 7, how it does so is up to the utility. *See* City-CUB Init. Br. at 107-08.

The Companies' conclusory argument that no party has proposed a "definable and supportable" alternative to Peoples Gas's rate increase allocation (PGL-NS Init. Br. at 159) ignores Mr. Glahn's specific alternative allocation of the revenue increase, which is more akin to an "equal percentage of revenue increase." GCI Ex. 3.0 (Rev.) at 14, L. 1-6. In particular, Mr. Glahn set S.C. 6 and 8 at their assumed cost of service, as Peoples Gas did, but imputed the average system increase (26.6 percent) to S.C. 7, to reflect the increase in the cost of serving customers in that class. To better serve horizontal equity, Mr. Glahn allocated the same 21% increase to S.C. 2, 3 and 4, moving S.C. 2 to 121 percent of cost and S.C. 3 and 4 to 107 percent and 116 percent above cost, respectively. This is a more equitable allocation for the business classes than having S.C. 2 at 121 percent of cost, while having the combined S.C. 3 and 4 class at cost, as Peoples Gas proposes.[12] *Id.* at 14-15. Nor should the Commission be distracted by the Companies' sweeping misstatement that other parties' alternatives to Peoples Gas's proposed

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[12] According to Ms. Grace, if Peoples Gas's proposed rate design were approved, S.C. No. 3 would be slightly above cost at 100.9 percent, while S.C. No. 4 would be slightly below cost at 98 percent. If the utilities' proposal to consolidate these two service classifications were approved, the combined class would be at cost. NS/PGL Ex. VG-2.0 at 15-16, L. 319-23.

alternatives to the utility's rate increase allocation were "arbitrarily derived." PGL-NS Init. Br. at 159.[13]

Peoples Gas's allocation of its proposed rate increase violates the principle of horizontal equity by treating business customers in S.C. 2 and combined S.C. 4 differently. In addition, the utility has improperly failed to allocate to S.C. 7 any of the increase in the cost to serve that class. GCI's alternative allocation, which more equitably apportions the rate increase among Peoples Gas S.C. 2 and combined S.C. 4 and properly imputes a portion of the proposed rate increase to S.C. 7. Accordingly, the Commission should reject Peoples Gas's proposed allocation of its rate increase and instead adopt GCI's alternative allocation.

3. Other Rate Design Considerations

The Companies' assertion that GCI witness Glahn's rate design proposals are "headed in the wrong direction" and do not "represent sound and modern regulatory policy" cannot be taken seriously. PGL-NS Init. Br. at 163. This baseless claim is grounded in the Companies' hopeless narrow focus on recovering a greater portion of its fixed costs through fixed charges – to the exclusion of established rate design objectives such as stability and gradualism, social goals and fairness. The utilities' rate design proposals sacrifice these crucial objectives and others in the name of "cost and revenue alignment." *Id.* at 162. The Companies do not deny that the other rate design objectives identified by the AGA are substantial; in fact, they *say* their proposals are designed to comport with gradualism. *See id.* at 159. Nevertheless, as discussed below, the

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13 Equally meritless is Peoples Gas's suggestion that other parties' rate increase allocation proposals should have been "accompanied by analysis" showing their proposals' impact on customers' total bills. *Id.* This case does not concern every component of customers' bills; it concerns the distribution component of such bills. Returning the focus to the proper scope of this proceeding, Mr. Glahn's distribution rate increase allocation should be adopted because it is more fair and equitable than Peoples Gas's proposal.

Companies' customer charge proposals utterly fail any test for stability and gradualism by imposing rate shock on particular customers, many of whom are among the utilties' most vulnerable customers. Thus, it is the Companies' proposals – not Mr. Glahn's – that stand in the way of enlightened ratemaking.

The Companies seek to justify their insistence on increasing fixed charges by citing the Commission's twelve-year-old decision in Peoples Gas' last rate case. *See id.* at 155. Although the Companies correctly recite the Commission's statement in *In re Peoples Gas Light & Coke Co.*, ICC Docket No. 95-0032, Order at 51 (Nov. 8, 1995), that Peoples Gas's $9.00 S.C. 1 customer charge should be "increased in future proceedings to move it closer to cost," that comment cannot be used to impose rate shock in this case. After all, the Commission's statement was made more than a decade ago, in the context of Peoples Gas's last rate case and the particular proposals in that docket. The Commission could not have foreseen that the utilities would defer filing this rate case for more than a decade, what level of costs they would seek to recover, how they would allocate those costs among the rate classes or that they would propose bifurcation of S.C. 1 in this case. Tellingly, the Commission did not order Peoples Gas to increase its S.C. 1 customer charge by a particular amount – let alone to propose separate charges for the utility's residential heating and non-heating customers. Taken out of the specific context in which it was made, the Commission's remark lacks the precedential effect the Companies assert that it has.

C. Service Classification Rate Design

2. Contested Issues

a. Peoples Gas Service Classification Nos. 1H and 1N

i. Bifurcation of Peoples Gas S.C. No. 1

For the reasons set forth in section VIII.B.2.c. above, the Companies' proposal to bifurcate Peoples Gas S.C. 1 should be rejected.

ii. Customer Charges for S.C. 1N and 1H

(a) Peoples Gas Proposal

The Companies rely on their fatally flawed proposal to bifurcate S.C. 1 as a basis for establishing proposed monthly customer charges that are substantially higher for S.C. 1H than S.C. 1N customers. Peoples Gas proposes to increase its customer charge for S.C. 1H customers from $9.00 to $19.00 per month – a 111 percent increase – and the corresponding charge for S.C. 1N customers from $9.00 to $11.25 per month.[14] *See* NS/PGL Init. Br. at 166. The Commission should deny Peoples Gas's request to impose customer charges that would harm its low- and fixed-income customers and send an improper price signal. Nothing in the utilities' Initial Brief establishes otherwise.

In particular, Mr. Glahn's testimony that substantially higher customer charges for S.C. 1H customers would harm low- and fixed-income customers – in violation of the AGA's "social goals" rate design consideration – stands unrebutted. *See* City-CUB Init. Br. at 113-16. Additionally, the Companies' criticism that the GCI did not provide a bill impact analysis does (*see* PGL-NS Init. Br. at 163) is meritless. The simple reason Mr. Glahn did not address total bill

[14] These proposed charges are based on rates without Rider UBA.

impacts is that such impacts are irrelevant to his fundamental point: low- and fixed-income customers are more adversely affected by higher fixed customer charges than higher distribution charges because the former charge, unlike the latter, cannot be managed through reducing consumption. *See* GCI Ex. 6.0 (Rev.) at 12, L. 290-92. The Companies' insistence that they should be allowed to recover an increased portion of their costs of service through fixed customer charges also utterly ignores this straightforward principle. *See, e.g.*, PGL-NS Init. Br. at 162-63.

Even assuming *arguendo* that Ms. Grace is correct about low-income customers' gas consumption levels, that assumption does not justify more than doubling fixed charges for S.C. 1 heating customers. As discussed in section VIII.B.2.c. above, the solution that both protects low-income customers and – unlike the Companies' proposal to lower distribution charges – sends a proper price signal is targeted energy efficiency assistance programs that provide low-income customers with weatherization and energy efficient appliance rebates to control gas usage. City-CUB Init. Br. at 115-16.[15] Indeed, Peoples Gas's proposal to lower distribution charges is itself ground for rejecting its rate design proposals for S.C. 1N and 1H, for the reasons discussed in City-CUB's Initial Brief – namely, that it violates the AGA's "conservation of resources" and "environmental protection" rate design goals. *Id.*

That we have identified these problems with lower distribution charges should not be misconstrued as support for any unreasonable or inequitable increases in volumetric rates. Indeed, the Companies' proposed allocation of gas cost related uncollectible expense is a

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[15] The degree of the impact also depends on the size of the revenue requirement that will be recovered through fixed and volumetric charges. To the extent the Commission is concerned about the impacts on customers' bills of the Companies' rate design proposals, approving a lower revenue requirement – such as that proposed by Staff – would reduce such impacts. *See* Staff Init. Br. at 235, n.35; Sep. 14, 2007 Tr. at 1488-89.

particularly egregious example of such an inequitable allocation that City-CUB do not support. The Companies' proposal, described at pages 160-162 of their Initial Brief, allocates (1) 78.7% of the uncollectible expense to S.C. 1 heating customers, and (2) then allocates 67% that share of the expense to the first block volumetric charge for S.C. 1 heating customers, triggering an increase of more than five cents to this per-therm charge solely for gas cost uncollectible expense. *See* Ex. VG 2.3-PGL. This proposal would exacerbate the inequities of bifurcating S.C. 1 customers into heating and non-heating customers, contributing to the rate shock S.C. 1 heating customers face if the Companies' proposed customer charges are adopted. The Companies' proposed allocation of gas cost uncollectible expense deviates from the rate design goals of stability and gradualism, and highlights yet another reason to maintain S.C. 1 as a single class.

In lieu of Peoples Gas's unreasonable proposed customer charges for S.C. 1, the Commission should adopt Mr. Glahn's recommended S.C. 1 customer charges.[16] Consistent with his recommendation to keep S.C. 1 whole, Mr. Glahn proposes setting the monthly customer charge for Peoples Gas S.C. 1 at no more than $10.50. If approved, this proposal would require that the distribution charge for S.C. 1 be adjusted to meet the Commission-approved revenue requirement for Peoples Gas. GCI Ex. 3.0 (Rev.) at 32, L. 7-9. Mr. Glahn's proposed increase in customer charges would avoid placing an undue hardship on low- and fixed-income customers, as the Companies' proposed charges would. *See id.* at 31-32. Additionally, as shown in GCI Ex. WLG -3.1, Schedule 6, Mr. Glahn's proposed customer

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[16] Mr. Glahn's proposed customer charges for North Shore S.C. 1 customers are discussed in section IX.C.2.b. below.

charges would be comparable to the customer charges for similar rate classes of other Illinois investor-owned natural gas utilities.

In their Initial Brief, the utilities baselessly depict Mr. Glahn's reasoned customer charge proposal as a "seat of the pants" analysis. NS/PGL Init. Br. at 168. This absurd claim completely ignores Mr. Glahn's testimony establishing that his proposed charges meet rate design objectives such as social goals and stability that the Companies' proposals utterly fail to address. *See* GCI Ex. 3.0 (Rev.) at 27-33. Additionally, that Mr. Glahn's proposed charges – unlike Peoples Gas's – are comparable to those of other LDCs regulated by the Commission does not make it "arbitrary." PGL-NS Init. Br. at 167. Rather, that favorable comparison merely indicates that Mr. Glahn's proposals share a rate design philosophy the Commission has accepted as reasonable for such fixed charges. Certainly, that philosophy is more worthy of adherence than the Companies' "we know what's best for consumers" approach.

Unlike Peoples Gas's proposed customer charges for S.C. 1, GCI's proposal is properly based on cost as well as other established rate design criteria. Accordingly, the utility's proposal should be rejected and GCI's alternative proposal adopted.

(b) Staff Proposal

For the reasons discussed in City-CUB's Initial Brief at 117-18, the Commission should decline to adopt Staff witness Mike Luth's proposed customer charges for S.C. Nos. 1N and 1H. *See* Staff Init. Br. at 237-38.

b. North Shore Service Classification Nos. 1N and 1H

For the reasons discussed in section VIII.B.2.c. above, the Companies' proposal to bifurcate North Shore S.C. 1 into heating and non-heating subclasses should be rejected.

With respect to customer charges for S.C. 1, North Shore proposes increasing its monthly customer charge for S.C. 1H from $8.50 to $16.00 per month – an 88 percent increase – and to increase the corresponding charge for S.C. 1N customers from $8.50 to $10.50 per month. PGL-NS Init. Br. at 166; Staff Init. Br. at 238-39. For the reasons discussed above with respect to the Companies' and Staff's proposed increases in Peoples Gas's customer charges, their proposed customer charges for North Shore should also be rejected. Instead, the Commission should adopt Mr. Glahn's recommendation to keep North Shore S.C. 1 whole and maintain the existing $8.50 monthly customer charge for that class. *See* City-CUB Init. Br. at 118. For the same reasons discussed above with respect to customer charges for PGL S.C. 1, the Companies' conclusory challenge to Mr. Glahn's proposed customer charges for NS S.C. 1 also fails. *See* PGL-NS Init. Br. at 168.

c. Peoples Gas Service Classification No. 2

Peoples Gas proposes increasing the monthly customer charge for its S.C. No. 2 Meter Class 1 from $15.00 to $21.00. For its S.C. No. 2 Meter Class 2, the utility seeks an increase from $22.00 to $60.00 – a 173 percent increase. *See* PGL-NS Init. Br. at 169. To avoid imposing rate shock on S.C. 2 customers and to meet the rate design objective of gradualism, Mr. Glahn recommends limiting the new customer charge for Meter Class 1 to no more than $19.00. GCI Ex. 3.0 (Rev.) at 32, L. 3-5. This charge would match the comparable customer charge for MidAmerican and "fall in the midst of the other comparable [Illinois] utilities' rates." *Id.* at 34, L. 4-6. For Meter Class 2, Mr. Glahn recommends limiting the new customer charge to $27.00. This proposed charge is higher than that of MidAmerican and somewhat below the comparable charges of some Illinois utilities with two-tiered rates, but it is appropriate given Peoples Gas's declining block structure for volumetric charges. *Id.* at 34, L. 6-8; *see also* GCI Ex. 3.1, Sch. 6.

The Commission should not be misled by the Companies' attempt to recast Mr. Glahn's comparison of his proposed customer charges with those of comparable Illinois utilities as the basis for his proposal. *See* PGL-NS Init. Br. at 170. As with his proposed customer charges for S.C. 1, Mr. Glahn's recommended customer charges for S.C. 2 are designed to avoid rate shock and to comport with gradualism, *see* GCI Ex. 3.0 (Rev.) at 29-34 – objectives the Companies' proposals fail to meet. That the resulting charges also happen to fall within the range of such charges imposed by other Illinois utilities merely demonstrates that they fall within a reasonable range – an indication that they are not "arbitrary," as the Companies assert. PGL-NS Init. Br. at 170.

d. North Shore Service Classification No. 2

North Shore proposes increasing the monthly customer charge for its S.C. No. 2 Meter Class 1 from \$15.00 to \$17.00. As with Peoples Gas S.C. 2 Meter Class 2, North Shore seeks to increase the customer charge for Meter Class 2 from \$22.00 to \$60.00 – a 173 percent increase. *See* NS/PGL Init. Br. at 170. For the reasons discussed in City-CUB's Initial Brief at 120, GCI recommend retaining the respective \$15.00 and \$22.00 charges for Meter Classes 1 and 2. And for the reasons discussed with respect to proposed customer charges for Peoples Gas S.C. 2, the Companies' criticism of Mr. Glahn's proposed North Shore S.C. 2 charges as "arbitrary" (*id.* at 171) is baseless.

f. Peoples Gas Service Classification No. 4

For the reasons discussed in section IX.B.1. and the City-CUB's Initial Brief at 108-09, the rates for Peoples Gas S.C. 4 should be adjusted to move the class from 96 to 116 percent of the class's cost of service. Rates for Peoples Gas S.C. 3, which the Companies propose to combine with People Gas S.C. 4, should be set at 107 percent of cost. *See id.*

g. Peoples Gas Service Classification No. 7

For the reasons discussed in section IX.B.1. above and in City-CUB's Initial Brief at 107-08, 26.6 percent (the average system increase) of Peoples Gas's proposed rate increase should be apportioned to Peoples Gas S.C. 7.

D. Tariffs – Other Tariff Issues

2. Charge for Dishonored Checks and/or Incomplete Electronic Withdrawal

The Companies propose to increase the charge for dishonored checks and/or incomplete electronic withdrawal from $10.00 to $25.00. PGL-NS Init. Br. at 177. Because the Companies have failed to provide a cost basis for their proposal, it should be rejected.

According to the Companies, the proposed $25.00 charge reflects "the prevailing rates for such checks and transactions" and would "discourage customers from making deficient payments to the Companies." *Id.* Conspicuously absent from this assertion is any reference to the actual costs the utilities incur in dealing with dishonored checks or incomplete electronic withdrawals. *See* City-CUB Init. Br. at 121; GCI Ex. 3.1, Sch. 7. Instead, the Companies' proposal appears to be based on the order in an eight-year-old MidAmerican case (Docket No. 99-0534) and Staff witness Harden's Direct Testimony in this case (NS/PGL Ex. 2.0 at 52, L. 1159-60), which cites the MidAmerican case as the sole basis for her endorsement of the utilities' proposal. *See* Staff

Ex. 9.0 at 11, L. 221-27; *see also* Staff Init. Br. at 241. Because there is no cost basis in this record to support the proposed $25 charge, the charge for dishonored checks and incomplete withdrawals should be maintained at its current level. *See* City-CUB Init. Br. at 121.

XIII. CONCLUSION

For the reasons discussed in this Reply Brief and in our Joint Initial Brief , the City and CUB respectfully request that the Commission reject Peoples Gas's rate increase as proposed. Instead, PGL's proposal should be modified as set forth in this brief.

In addition, CUB respect fully requests that the Commission reject North Shore's rate increase as proposed. Instead, North Shore's proposal should be modified as set forth in this brief d in the City-CUB Joint Initial Brief.

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Respectfully Submitted,

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