STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	:	
	:	
Proposed general increase in natural gas rates (tariffs filed March 9, 2007)	:	**Docket No. 07-0241**
	:	
	:	**(cons.)**
The Peoples Gas Light and Coke Company	:	
	:	
Proposed general increase in natural gas rates (tariffs filed March 9, 2007)	:	**Docket No. 07-0242**
	:	

REPLY BRIEF OF THE
STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Table of Contents

Page

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

North Shore Gas Company **Proposed general increase in natural gas rates (tariffs filed March 9, 2007)**	: : : : :	**Docket No. 07-0241**
	:	**(cons.)**
The Peoples Gas Light and Coke Company **Proposed general increase in natural gas rates (tariffs filed March 9, 2007)**	: : : : : :	**Docket No. 07-0242**

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Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, pursuant to Section 200.800 of the Rules of Practice (83 Ill. Adm. Code 200.800) of the Illinois Commerce Commission's ("Commission"), respectfully submits its Reply Brief in the above-captioned matter regarding the filings by North Shore Gas Company ("North Shore" or the "Company") and The Peoples Gas Light And Coke Company ("Peoples Gas" or the "Company") (collectively referred to as the "Companies') for proposed general increases in rates for gas service.

I. INTRODUCTION

The Initial Brief of the Staff of the Illinois Commerce Commission ("Staff's Initial Brief" or "Staff IB") was served on October 12, 2007. The Initial Brief Of The People Of The State Of Illinois ("AG's Initial Brief" or "AG IB"), the Initial Brief Of The City of

Chicago Regarding Proposed Rider ICR ("City's ICR Initial Brief" or "City ICR IB"), the Joint Initial Brief Of The City Of Chicago And The Citizens Utility Board ("City-CUB's Initial Brief" or "City-CUB IB"), the Initial Brief Of Constellation NewEnergy-Gas Division, LLC ("CNE-Gas' Initial Brief" or "CNE-Gas IB"), CUB Initial Brief On The Issue Of Peoples Gas Light And Coke Company's Proposed Rider ICR ("CUB's ICR Initial Brief" or "CUB ICR IB"), the Initial Brief Of Environmental Law And Policy Center ("ELPC's Initial Brief" or "ELPC IB"), the Illinois Industrial Energy Consumers Initial Brief ("IIEC's Initial Brier" or "IIEC IB"), the Initial Hearings Brief Of Multiut Corporation ("Multiut's Initial Brief" or "Multiut IB"), the Initial Brief Of Nicor Advanced Energy L.L.C. ("NAE's Initial Brief" or "NAE IB"), the Initial Post-Hearing Brief Of North Shore Gas Company And The Peoples Gas Light And Coke Company ("NS-PGL's Initial Brief" or NS-PGL IB"), the Initial Brief Of The Retail Gas Suppliers ("RGS' Initial Brief" or "RGS IB"), the Initial Brief Of Local Union No. 18007, Utility Workers Union Of America, AFL CIO ("UWUA's Initial Brief" or "UWUA IB"), and the Initial Brief of Vanguard Energy Services, L.L.C. ("Vanguard's Initial Brief" or "Vanguard IB") were also filed or served on October 12, 2007.

Some of the issues raised in the parties' initial briefs were addressed in Staff's Initial Brief and, in the interest of avoiding unnecessary duplication, Staff has not repeated every argument or response previously made in Staff's Initial Brief. Thus, the omission of a response to an argument that Staff previously addressed simply means that Staff stands on the position taken in Staff's Initial Brief.

II. RATE BASE

D. Reserve for Accumulated Depreciation and Amortization

1. GCI's Proposed Adjustments

The People Of The State Of Illinois ("AG'") and the Citizens Utility Board ("CUB") and the City Of Chicago ("City") (collectively, "CUB-City") continue to support Mr. Effron's adjustment to add a full year of depreciation expense to Accumulated Depreciation and Amortization for plant in service at the end of 2006. The AG and CUB-City argue that Mr. Effron's adjustment is necessary to correct for the Companies' one sided and selective adjustments for FY 2007 plant additions (AG IB, p. 6; CUB-City IB, pp. 9-16). After further evaluating the positions advanced by the various parties in testimony and briefs, Staff withdraws its objections to Mr. Effron's adjustment. In particular, Staff no longer supports the position that Mr. Effron's adjustment violates 83 Ill. Adm. Code Section 287.40. The impact on the rate base of Peoples Gas is to increase the accumulated depreciation reserve $43,134,000 (GCI Exhibit 5.1, Schedule B-1 Revised) and deferred income taxes $587,000 (GCI Exhibit 5.1, Schedule B – 2 Revised). The impact on the rate base of North Shore Gas is to increase the accumulated depreciation reserve $5,721,000 (GCI Exhibit 5.2, Schedule B-1 Revised) and deferred income taxes $15,000 (GCI Exhibit 5.2, Schedule B – 2 Revised).

E. Cash Working Capital

Both Staff and the Companies agree that the cash working capital ("CWC") requirement for North Shore and Peoples Gas should be recalculated using the gross lag methodology (Staff IB, p. 6; NS-PGL IB, p. 21). Staff maintains that the CWC requirement should be calculated using the format presented in ICC Staff Exhibit 15.0 Corrected, Schedules 15.1 N and P (ICC Staff Exhibit 3.0, pp. 7-8). The calculation should include all of the Companies' day-to-day cash flows in determining their CWC requirements (ICC Staff Exhibit 15.0 Corrected, p. 7, lines 143-152). Items should not be considered in the lead and lag days calculation if the items are not also used in subsequent steps of the calculation. (ICC Staff Exhibit 15.0 Corrected, pp. 11-12, lines 221-249).

Pass-Through Taxes Lead Days and Separate Treatment of Real Estate Taxes

While the Companies considered $206 million of pass-through taxes in the $224 million of taxes other than income used to calculate lead days, only $17.6 million of Taxes Other Than Income Taxes were included in the Companies' CWC requirement calculation (ICC Staff Exhibit 15.0 Corrected, pp. 11-12, lines 221-249). This skews the results of the calculation. To correct for the Companies' skewing of lead days toward the heavily weighted pass-through taxes, Staff maintains that real estate taxes should be treated separately for the effect of lead days for real estate taxes in the CWC requirement calculation as presented in ICC Staff Exhibit 15.0 Corrected, Schedules 15.1 N and P, pp. 1 and 4.

The Companies maintain that pass-through taxes have an impact on cash flow and should be taken into account when determining the expense lead time of Taxes Other Than Income Taxes (NS-PGL IB, p. 26). However, the Companies considered pass-through taxes only in calculating lead days of Taxes Other Than Income Taxes, but did not include the dollars associated with pass-through taxes in the Companies' cash flow for the CWC requirement calculation. The Companies should not be allowed to recognize the effect that pass-through taxes lead days have on the CWC requirement calculation and then ignore the effect pass-through taxes cash inflow and outlays have on the CWC requirement calculation. At $206 million, pass-through taxes would be the second greatest cash outlay in the Companies' CWC requirement calculation. Staff is not recommending that the cash outlays of pass-through taxes be included in the CWC requirement calculation. As such, real estate taxes should be considered separately so that the lead days of pass-through taxes are not allowed to dilute the effect of the more than one-year lead time before payment of real estate taxes.

Inclusion of Capitalized Expenses

Despite North Shore and Peoples Gas claim it is not Staff's position that cash working capital should be defined as "the amount of cash a company needs to keep on hand to meet its cash operating expenses after taking into account its cash revenues." (NS-PGL IB, p. 23) Staff maintains that all cash flows associated with the Companies' day-to-day operations should be considered in the Companies' CWC requirement calculation (ICC Staff Ex. 3.0, p. 3) not just those related to operating expenses. Staff included capitalized payroll, pensions and benefits in the CWC requirement calculation because these items reflect cash outlays of the Companies' normal day-to-day operations (ICC Staff Exhibit 15.0 Corrected, pp. 7-9). Staff's primary definition of CWC is the amount of funds required from investors to finance the day-to-day operations of the Companies" (ICC Staff Exhibit 3.0, p. 3, Lines 49-50). At NS-PGL's IB, p. 24, the Companies' citing of Illinois Power Company's Petition for approval of Delivery Services Implementation Plan and their Petition for approval of Delivery Services Tariffs, Docket Nos. 99-0120/99-0134 (Cons.) (Order entered August 25, 1999, pp. 63-64) is not supportive of their argument. The order states that there is no double counting of an adjustment to exclude accounts payable from rate base since accounts payable, not being a cash flow, is not reflected in the CWC allowance. The issue here is the <u>inclusion</u> of items which <u>are</u> cash flows.

The Companies attempt to confuse the inclusion of the effect of capitalized cash outlays in the CWC requirement calculation with the inclusion of capitalized cash outlays in rate base (NS-PGL's IB, p. 24). If capitalized cash outlays are not to be considered in CWC to prevent double counting of the cash outlay as plant in rate base and as CWC, then non-capitalized cash outlays should also not be considered in CWC because the cash outlay is already considered in the revenue requirement as an operating expense. Under the Companies' rationale, there would never be a CWC requirement as most cash outlays represent either an operating expense or a component of rate base . The CWC requirement adjusts rate base to provide a return on the cash a company needs to keep on hand to meet its cash operating outlays after taking into account its cash inflows.(ICC Staff Exhibit 3.0-Supplemental Corrected, p 4, Lines 64-67).

F. Gas in Storage

1. Working Capital

The Companies dispute Staff's recommendation to reduce Peoples Gas' working capital allowance for gas in storage by $13,549,797 and North Shore's allowance by $1,422,772. In particular, the Companies claim that having their inventory levels at Manlove higher than their planned withdrawal levels is not a genuine issue, noting that all gas storage in Manlove is either base gas or top gas. (NS-PGL IB, p. 28) The Companies also indicate that the fact that all of the gas is not cycled does not mean the gas does not exist and if the gas exists then the Companies should receive a return on this gas. (Id., p. 29) Staff disagrees.

Staff's Initial brief, pages 11 to 14, already discusses that Peoples Gas admitted its excess test year inventory is due to warmer than normal weather in the test year, Staff demonstrated the test year volumes are significantly higher than either Companies historic gas storage volumes, and that Staff normalized the gas storage volumes requested by the Companies to determine a normalized working capital allowance for gas in storage. Therefore, those arguments need not be repeated. However, Staff is compelled to further respond to the Companies above statements.

First, the Companies arguments only address inventory volumes at Manlove field and do not consider leased storage. However, the record clearly indicates that Staff's analysis relied on normalized storage levels to determine each Companies working capital allowance for gas in storage and considered three leased storage services in addition to Manlove field for Peoples Gas (Staff Ex. 23.0, Schedule 23.2P) and considered two leased storage services in addition to Manlove field for North Shore. (Staff Ex. 23.0, Schedule 23.2P) The Companies' attempt to muddy the discussion by solely addressing its concerns regarding Manlove is disingenuous and the Commission should give it no weight.

Second, pursuant to Section 9-101 of the Public Utilities Act ("PUA) (220 ILCS 5/1-101 et seq.), the Companies are only allowed to charge just and reasonable rates. In setting those rates the Commission has historically viewed larger than normal values for gas in storage as not just and reasonable. For example, Staff has previously reviewed the working capital allowances for a gas utility and found the test year volumes for that utility were larger than historical levels due to warmer winter weather. Staff concluded those test year amounts were higher than normal and recommended to the Commission that they be adjusted downward. (ICC Docket Nos. 02-0798, 03-0008, 03-0009, October 22, 2003 Order, p. 21) Further, the Commission accepted Staff's arguments that the storage inventory levels were excessive and reduced the working capital allowances associated with gas in storage. (Id., p. 22) Therefore, the Companies' claim that Staff's adjustment is not genuine ignores the necessity to normalize rates to ensure those rate are just and reasonable and ignores prior Commission actions. Therefore, the Commission should reject the Companies' arguments.

2. Accounts Payable

Staff maintains that the Companies' storage gas inventory should be adjusted by the associated accounts payable. Staff based the amount of this adjustment on accounts payable figures provided by the Companies in a data request response (ICC Staff Exhibit 15.0 Corrected, Schedules 15.3 N and P, p. 2).

The Companies' argument over an historical test year verses a future test year does nothing to indicate that accounts payable will not continue to exist. The Companies' reference to regulatory lag (NS-PGL IB, p. 31) is misplaced and should not be considered.

The Companies' also argue that accounts payable are eventually paid (NS-PGL IB, p. 30) and then would not exist. However, this argument does not change the fact that the accounts payables exist. The Companies' assertion that accounts payableare paid within sixteen days confirms (NS-PGL IB, p. 29), rather than disproves, that the accounts payable exist. Regardless of when the accounts payable were paid, the fact remains that costs for gas in storage are continually being incurred and that there is a continual level of gas in storage that is supported by accounts payable. Therefore, the Companies should not earn a return on that gas in storage.

G. OPEB Liabilities and Pension Asset/Liability

North Shore and Peoples Gas maintain that the adjustment proposed by the People Of The State Of Illinois ("AG""), the City of Chicago ("City") and the Citizens Utility Board ("CUB") (collectively, "GCI") to reduce the Companies' rate bases by the accrued liability for other post-employment benefits ("OPEB"), adopted by Staff in rebuttal testimony, is "incomplete and one-sided and, therefore, should not be adopted." (NS-PGL IB, p. 31) The Companies further argue that if GCI's adjustments to reduce rate bases for the accrued OPEB liability is adopted, GCI's adjustment should be recalculated to include the Peoples Gas net pension asset of $110,000,000 and the North shore net pension liability of $24,000 (net of ADIT, respectively). (*Id*. at 31-32) Regarding Staff's position that the accrued pension asset/liability is properly excluded from rate base because it was not created with funds supplied by shareholders, the Companies argue that Staff's theory is incorrect because the Companies have made contributions to the pension plan, as discussed in a data response to Staff (*Id*. at 32).

The Companies argument lacks merit. The mere fact the Companies have made contributions to the pension plan as required by ERISA does not demonstrate that shareholders are entitled to earn a return on such funds. That is because the amount of pension contributions is determined according to the requirements of ERISA, while the amount of pension costs reflected in rates is based on actuarial determinations in accordance with SFAS 87. Thus, the amount of annual contributions to the pension and the amount of pension costs reflected for ratemaking purposes will be different. Nevertheless, the cash that was contributed to the pension plan was obtained from normal operating revenues collected from utility ratepayers and represent funds supplied by ratepayers. Moreover, there is no evidence in the instant proceeding demonstrating that specific funds were provided by shareholders through additional contributions to capital. The theoretical basis for Staff's inclusion of the accrued OPEB liability and the exclusion of the pension asset is that such funds are supplied by ratepayers, not shareholders. As such, shareholders are not entitled to earn a return on these funds. The Companies also point out that the test year revenue requirement reflects pro forma adjustments for lower anticipated 2007 pension costs. Nevertheless, the test year revenue requirements after these adjustments result in pension expenses of $10,203,532 and $2,867,129 for Peoples Gas and North Shore, respectively. This supports Staff's contention that pension costs are funded by ratepayers, not shareholders, since pension expense is one of the components of operating expenses that are recovered through base rates. Therefore, shareholders should not earn a return on the pension asset that was created with ratepayer funds, nor should they enjoy a cost-free source of capital provided by means of the accrued OPEB liability. Accordingly, it is proper to reduce utility rate base by the accrued OPEB liability and to exclude the pension asset from rate base.

Finally, the Companies refer to the Commission's order in *In re Commonwealth Edison Co.*, ICC Docket No. 05-0597 (Order July 26, 2006), in support of their position that the Commission has allowed recovery of a rate of return on a pension contribution made by the Company. (Id., p. 33) Staff notes that the facts and circumstances of the Commonwealth Edison case were very different from the instant proceeding. In Docket No. 05-0597, a contribution to equity was made by Commonwealth Edison's shareholders for the purpose of pre-funding the pension plan in an amount much greater than required. The Commission found that the evidence supported the contention that the pension asset was at least partially created by the capital injection supplied directly by Commonwealth Edison's shareholders. Even so, the Commission did not allow Commonwealth Edison to include the pension asset in rate base. Instead, the Commission opted for an alternative whereby the Commission attempted to derive a cost of debt that Commonwealth Edison would have experienced had Commonwealth Edison instead of Exelon issued debt to raise funds to make the pension contribution. (*In re Commonwealth Edison Co.*, ICC Docket No. 05-0597, p. 28 (Order on Rehearing December 20, 2006) Such an alternative would not be appropriate in the instant proceeding, however, because the evidentiary record does not demonstrate that: (1) shareholders provided the contributions that gave rise to the pension asset; (2) the Companies were pre-funding the pension in an amount much greater than that otherwise required; (3) there was a shareholder contribution; or (4) that the shareholder contribution benefited ratepayers more than it cost them. In Docket 05-0597, the Commission found that ratepayers were saved $30.2 million as a result of the contribution, which exceeded the $25.3 million cost proposed to be recovered from ratepayers. (Id., p. 28) Since the pension asset in the instant case was not derived from shareholder funds, shareholders are not entitled to earn a return on it. The ratepayers who supplied the contributions that created the pension asset are entitled to the earnings. As cited in Staff's Initial Brief, the Commission has found that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. Accordingly, the Commission has concluded that the pension asset should be eliminated from rate base in these circumstances. (Staff IB, p. 18)

III. OPERATING EXPENSES

C. Contested Issues

1. Storage Expenses

a. Crankshaft Repair Expenses (PGL)

Peoples Gas indicated that the Commission should approve the GCI proposed adjustment related to its crankshaft repair expense by $410,000 by amortizing its $546,000 test year expense over four years versus accepting Staff's recommendation to disallow all of the costs associated with the crankshaft repair, which would lead to an additional $136,000 expense reduction. (NS-PGL IB, p. 41) Staff disagrees.

Staff's initial brief fully discusses how no party disagrees with Staff that the crankshaft repair is a non-recurring event, how GCI agrees non-recurring events should be removed from a test year, and how Peoples Gas has no evidence in the record that its historical non-recurring expense amount equates to the costs associated with the crankshaft repair. (Staff IB, pp. 26-29) Staff's arguments fully support the designation of the crankshaft repair expense as non-recurring and as such that expense should be disallowed from the test year expense amounts recovered by Peoples Gas in the instant proceeding. Therefore, Staff's recommendation should be accepted.

b. Hub Services (PGL) (To be addressed in Section V, below)

2. Customer Accounts Expenses (Collection Agency Fees)

Staff maintains that the Companies pro forma increase for collection agency fees should be denied since the evidence reflects no need for it. (Staff IB, pp. 29-31) The Companies contend that Staff's position does not allow for the effect of the 2006 Gas Charge settlement on collection agency fees. (NS-PGL IB, pp. 42-44)

The Companies' adjustments must be rejected. The evidence is clear that the Companies have overstated these fees in excess of both historical 2006 test year levels and annualized 2007 amounts. (*See* Staff IB, p. 30) The Companies contend that collection agency fees will be "substantially more than experienced in the test year," but the data shows otherwise. (Id.) Collections take place for several years after a bill is turned over to a collection agency, and data for 2006 and 2007 does not indicate a return to the 2003 through 2005 level of collection agency costs. (ICC Staff Exhibit 13.0, p. 9) Thus, if anything, the record supports a finding that collection agency fees for the period when the rates being set will be in effect will be less than they were in the pre-2006 Gas Charge settlement numbers selected by the Companies for their proposed normalization adjustment.

Further, the Companies' position is that the only reason the test year fees are lower than years past is due to the 2006 Gas Charge settlement. (NS-PGL IB, pp. 42-43) The Companies fail to properly consider that under Sections F and G of the Settlement Agreement Amendment and Addendum (In re *Peoples Gas Light and Coke Co.*, ICC Docket No. 01-0707, Exhibit 2 (Order Mar. 28, 2006) ("*01-0707 Order*")) they agreed that they would (i) "… not pursue, directly or indirectly, collection of these amounts [(i.e., debt written off or relieved)] from customers …" and (ii) "not seek recovery in any future rate or reconciliation cases <u>of any amounts of debt written-off or relieved</u> …." (*Id.*) The Companies propose here to treat the debt written off or relieved as anomalies that should give rise to upward normalization adjustments in collection costs to be recovered from ratepayers. As such, the Companies' proposal attempts to recover costs related to the amount of debt written off by adjusting test year expenses in a manner that completely disregards such write-offs or assumes that such write-offs did not occur. Also, given that collection agency fees are determined in part by the amount of outstanding account balances (North Shore/Peoples Gas Ex. LK-2.0, p. 6, lines 131-133), it would be improper to base collection agency fees for the test year case upon prior years collection agency fees which were determined in part by accounts subsequently written off pursuant to the settlement agreement.

Staff's adjustments to deny the Companies' unsubstantiated and improper increases are sound and warranted, and should be adopted by the Commission.

3. Administrative & General Expenses

a. Injuries and Damages Expenses

Staff and the Companies continue to disagree on the proper amount for injuries and damages expense. (Staff IB, pp. 33-34 and NS-PLG IB, pp. 44-46) Staff appropriately believes that injuries and damages expense should be normalized over the five year period, 2002 through 2006. The Companies argue that if Mr. Griffin had used a different period for his analysis – the results would have been different. (NS-PGL IB, p. 46) While this may be true, the Companies' objection to a five year normalization period is not consistent with the Commission's decision in the recent Ameren rate cases in which it approved an injuries and expense allowance based on a 5-year payout period and also rejected attempts to exclude years which are not true outliers from a normalization calculation. (Central Illinois Light Company, et al., ICC Docket Nos. 06-0070, 06-0071, and 06-0072 Consol., Order dated November 21, 2006, pp. 48-49 and Staff IB, p. 33) The record shows that a five year period is consistent with this prior Commission ruling and therefore the Companies' claim that the period is arbitrary is false. (NS-PGL IB, p. 46)

The Companies' further argue that Mr. Griffin's adjustment is immaterial (i.e., given "the relative closeness of this expense in the test year to the five year period chosen by Mr. Griffin, there is no good reason why the expense should be normalized.") (NS-PGL IB, p. 46) As set forth in Staff's Initial Brief, the difference between the Companies' proposal and Mr. Griffin's is significant. The difference between normalized and actual injuries and damages expense is fourteen percent for Peoples Gas and twenty-two percent for North Shore. (Staff IB, pp. 32-33)

For Peoples Gas and North Shore the total five year total injury and damages accrual is $32,150,000 and $3,482,000, respectively. (ICC Staff Exhibit 16.0, Schedule 16.2P/N, Column (b), Line 6) However, the amount paid out is less, only $27,216,000 and $2,725,000, respectively, were actually paid out in injuries and damages. Thus, the actual amounts paid out were 84.65% and 78.26%, respectively, of the expense accrued. ($27,216,000 / $32,150,000 and $2,725,000 / $3,482,000) Staff witness Griffin then applied the payout ratio of 84.65% and 78.26% to the 2006 test year accrual of $6,192,000 and $477,000, respectively, to determine the appropriate injuries and damages expense of $5,242,000 ($6,192,000 x 84.65%) and $373,000 ($477,00 x 78.26%). (Id., Line 9)

In conclusion, the evidence presented by Staff:

1. Demonstrates that over a 5-year period, Peoples Gas paid out 84.65% of the injuries and damages accrued; North Shore paid out 76.26% of the amount accrued;

2. A five year determination period was approved by the Commission in the 2006 Ameren rate orders;

3. The Commission has rejected attempts to exclude years which are not true outliers from normalization calculations; and

4. The test year revenue requirement will be overstated without Staff's adjustments.

Therefore, the Commission should approve Staff's injuries and damages expense adjustments.

b. Incentive Compensation Expenses

Peoples Gas and North Shore seek to recover $5,376,000 and $576,000, respectively, of incentive compensation program costs in connection with the instant proceeding. The Companies assert that these costs are "prudent and reasonable in amount, and the Utilities should be allowed to recover them". Staff and GCI propose to disallow these costs in their entirety. In the alternative, Peoples Gas and North Shore seek to recover $1,009,240 and $94,204, respectively, under the Team Incentive Award ("TIA") plan, and $625,791 and $53,107 under the Individual Performance Bonus ("IPB") plan, respectively. The Companies further assert that they must offer incentive compensation in order to provide the competitive compensation package necessary to attract and to retain high-quality employees. As such, according to the Companies' rationale, these costs are prudent and should be reflected in base rates. The plans at issue include the TIA plan, the IPB plan, the Short-term Incentive Compensation ("STIC") plan, and affiliate charges from Peoples Energy Corporation for officers' incentive compensation and bonuses, as well as expenses for restricted stock and performance shares (NS-PGL IB, pp. 47-53).

Staff witness Pearce has described in detail the performance measurements that provide the basis for awards under each of these plans, and the reasons that Staff opposes recovery of the cost of these plans in base rates. (Staff IB, pp. 34-40) Some of the plans are based on financial measures that benefit shareholders, not ratepayers. Other plans include a combination of financial and operational measures upon which the Companies may choose to base the award. The basis for the awards may change annually. Thus, the basis for the award may benefit customers one year and may benefit shareholders the next. In other words, the performance measures may be manipulated to show ratepayer benefit during the test year, with no assurance that the same performance measures will be applied in succeeding years. The awards are discretionary and may not even be paid in succeeding years. Thus, the Companies seek to recover the costs of these plans as a binding and fixed expense, although the basis and amount of the awards are discretionary.

The matter of incentive compensation is not a new issue before the Commission. Accordingly, parties on both sides of this issue have cited numerous prior cases in which the Commission has decided upon the treatment of incentive compensation costs for ratemaking purposes. Those cases include examples that range from complete disallowance to partial recovery of such costs. The Companies' primary contention is that incentive compensation costs are reasonable and prudent because they are necessary "to attract and retain a sufficient, qualified, and motivated work force." (*Id*. at 47) In response to Staff's argument that the Commission has not allowed recovery of incentive compensation costs without a demonstration of direct ratepayer benefits, the Companies have used the fallback argument that the plans at issue provide benefits to ratepayers.

The Companies also argue that the positions of Staff and GCI -- which rely on numerous Commission decisions describing the factual showing a utility must make with respect to whether benefits to ratepayers result from the incentive compensation costs – are contrary to the principle that a utility is generally allowed to recover costs prudently and reasonably incurred. (NS-PGL IB, pp. 49-50) The Companies' position is that if there is <u>any</u> benefit to the incentive compensation plans (such as helping to attract qualified personnel), then full recovery of such costs must be allowed -- notwithstanding the lack of a direct benefit to the provision of utility service and the existence of a primary purpose and direct link to shareholder specific benefits, such as earnings per share. The Companies are confusing the issue of whether the incentive compensation plans are prudent and reasonable incentive compensation plans from an overall business perspective – which legitimately includes all duties and obligations owed by management to its shareholders and does not include the protection of ratepayer interests that conflict with shareholder interests -- with the issues of (i) whether those costs represent prudently incurred costs for ratemaking purposes and (ii) whether inclusion of those costs in setting rates would result in just and reasonable rates. Pointing to statements by the witnesses that recognize these distinctions does nothing to support the Companies position.

Moreover, the Companies rely on a truncated and incomplete view of ratemaking principles. The law does not require the Commission to set rates which recover all costs of service posited by a utility. Section 9-101 of the PUA (220 ILCS 5/9-201) requires that rates and charges for services shall be just and reasonable. Pursuant to this statutory mandate, the Commission and the courts have found that a number of utility expenses (including expenses otherwise reasonable from a business perspective) should not be included in rates. The longstanding rule is that "the public is entitled to demand that no more be exacted from it than the services rendered are reasonably worth." *Public Utilities Commission v. Springfield Gas*, 291 Ill. 209, 217 (1920).

In *Illinois Bell Telephone v. Illinois Commerce Comm'n*, 55 Ill. 2d 461, 478-481 (1973), the court held that Illinois Bell was precluded from recovering expenses for lobbying, charity, civic and social club dues, and an unreasonably high licensing fee paid to A T & T. Similarly, in *DuPage Utility v. Illinois Commerce Comm'n*, 47 Ill. 2d 550, 560-561 (1971), the court upheld the Commission's disallowance of one half of the annual salaries of three officers of the utility found to be excessive and out of proportion to the nature and extent of the services rendered. In *Candlewick Lake Utility v. Illinois Commerce Commission*, 122 Ill. App. 3d 219, 227 (2nd Dist. 1984) the court, citing the *Illinois Bell* decision, held that a "utility has the burden of proving that any operating expense for which it seeks reimbursement directly benefits the ratepayers of the services which the utility renders." Thus, expenses are recoverable only when the utility can prove them to be reasonable, related to utility services, and of benefit to ratepayers or utility service. The showing required by the Commission for incentive compensation costs to be included in rates fits squarely within these ratemaking principles and is reasonable, and the Companies arguments to the contrary must be rejected.

Staff‘s primary support for its adjustment is that the incentive compensation plans are discretionary in nature and there has been no showing of demonstrated ratepayer benefit. Accordingly, Staff urges the Commission to deny recovery of 100% of the costs related to incentive compensation plans. If the Commission is determined to allow some portion of incentive compensation costs to be recovered through base rates, Staff‘s calculated alternative to complete disallowance of all incentive compensation costs would be adjusted to $282,486 for Peoples Gas and $26,368 for North Shore (18.8% of actual payouts of $1,502,584 and $140,253 for Peoples Gas and North Shore, respectively), based on the final payout percentages and amounts awarded under the TIA Plan (North Shore/Peoples Gas Ex. JCH/FLV-2.0, lines 137 - 146). Staff‘s revised alternative is based on reduction of calls to the call center (the same methodology described in Staff‘s rebuttal testimony, as previously cited). (Staff IB, pp. 34-35)

4. Invested Capital Taxes

GCI continues to oppose the Companies' adjustments for increased invested capital taxes although its two bases for opposition have been addressed and discounted. GCI's first objection is that the Companies' adjustments are based on receiving their entire rate increase request. (AG IB, p. 25; City-CUB IB, pp. 21-22) The Companies have agreed, though, to limit and adjust the increase for invested capital taxes to the increase approved in the final Commission order. (NS-PGL IB, p. 54) Therefore, GCI's objection based on this point is moot.

GCI's second objection is related to its belief that the increase in income could be paid out in dividends. (AG IB, p. 25) GCI's argument is contradicted by the record evidence indicating that the Companies' invested capital tax adjustment calculation is based on the Companies maintaining their current capital structures, which reflects an inherent dividend policy of maintaining the pro forma capital structure at all times. (Staff IB, p. 40; Staff Cross Ex. 2 (Fiorella)) Thus, GCI is incorrect that the Companies have presented no evidence regarding their dividend policy; rather, GCI has chosen to reject or ignore it. Accordingly, GCI's arguments to the contrary must be rejected. (City-CUB IB, p. 21)

The Commission should calculate the final level of invested capital taxes, in the manner shown by Staff in Appendix A and B Corrected to its Initial Brief, pp. 9 and 8, respectively, based on the final approved rate increases or decreases.

IV. RATE OF RETURN

C. Cost of Common Equity

1. Peoples Gas

Staff's Initial Brief thoroughly covered the analyses and arguments presented by the various parties' witnesses regarding the cost of equity. (Staff IB, pp. 52-77) Staff will comment further only in response to selected arguments of the Companies' and to one comment by CUB-City.

a. Risk Adjustment

While the Companies[1] criticized numerous parts of Staff's cost of equity analysis, which are addressed later in this reply brief, the difference between the results of the Companies' CAPM and DCF analyses, excluding adjustments, and Staff's is only 11 basis points. The major differences between the Companies' and Staff's cost of common equity recommendation are in the adjustments to the Utility Sample cost of common equity. The Companies witness, Mr. Moul, adjusted his results because (1) the market-value based common equity ratios of his sample were higher than the book-value based equity ratios for the Companies and (2) for flotation costs. Staff witness, Ms. Kight-Garlisch, adjusted her Utility Sample cost of common equity to reflect the lower financial risk of the Companies compared to the Utility Sample. (ICC Staff Exhibit 18.0, p. 2)

Relative Risk of the Companies and the Utility Sample

First, the Companies argue that Staff's financial risk adjustment is not necessary and that the samples credit ratings are comparable to the Companies. They further claim that Staff provided no evidence that it assessed the comparability of the Companies to the proxy group on any parameters besides business risk measures. (NS-PGL IB, pp. 83-86) The Companies allegations are completely false. Staff provided a detailed analysis that demonstrated that the financial risk of the sample is greater than the Companies. (Staff IB, pp. 54-58) Staff used the benchmark ratios as a measure of the financial strength the Companies would have the opportunity to attain

[1] Staff's arguments for Peoples Gas and North Shore are presented jointly in this section rather than appearing separately.

given their level of business risk and the impact of Staff's proposed revenue requirement and capital components and costs in this proceeding. The Commission should not ignore the level of financial strength implied by the benchmark ratios in comparing the riskiness of the Companies versus the proxy sample. Ignoring the significant risk differential between the Companies and the Utility Sample, as the Companies espouse, would clearly be inappropriate. The funds from operations ("FFO") interest coverage ratios and FFO to total debt coverage ratios for each of the Companies indicate that Staff's proposed rates are sufficient to support financial strength that is commensurate with a credit rating of AA for North Shore and AA- for Peoples Gas. Further, the Companies' imputed total equity to total capital ratio of 56% is at the higher end of the benchmark range for an AA credit rating. In contrast, the Utility Sample's average total equity to total capital ratio of 46% is at the lower end of the benchmark range for an A credit rating. Since the Companies' implied forward-looking credit ratings are higher than the average A S&P credit rating of the Utility Sample, a downward adjustment is necessary to reflect the basic tenet of financial theory -- the investor-required rate of return is lower for investments with less exposure to risk. (ICC Staff Exhibit 18.0, pp. 4-5) In addition, the Companies current S&P credit rating is affected by its non-regulated affiliations and is therefore not reflective of its stand alone risk. (Staff IB, pp. 54-58)

Next, the Companies assert that Staff's financial risk adjustment is inconsistent with its "position on Mr. Moul's financial leverage adjustment." (NS-PGL IB, p. 85) The Companies are wrong. Staff's Initial Brief provides a detailed discussion of the problems with Mr. Moul's market to book adjustment on pages 61 through 65. Further, Mr. Moul's adjustment for financial risk should not be necessary, since Mr. Moul argues that the risk of the proxy group is comparable to the risk of the Companies. (NS-PGL IB, pp. 83-84) However, Staff witness Kight-Garlisch determined that the financial risk of the Companies is lower than that of the proxy group, and thus a financial risk adjustment is required, as discussed above. (Staff IB, pp. 60-61)

Finally, North Shore claims that if anything, there should be an upward risk adjustment for North Shore due to its small size. (NS-PGL IB, p. 86) The Company's claim is completely unfounded. An increase in the cost of common equity recommendation to reflect the small size of North Shore is inappropriate. If a size-based risk premium for utilities exists, and Staff is not convinced that it does, it should be based on the size of the Company's parent company, Integrys. Although North Shore raises its own debt, it obtains common equity financing from its parent company. Integrys has a market capitalization of over $3.87 billion. Being a part of a much larger organization should enhance the ability of North Shore to access the common equity market on reasonable terms. The Commission has rejected the size-based risk premium in many cases, including Docket No. 03-0403.[2] (ICC Staff Exhibit 18.0, p. 3)

b. Effect of Rider Approvals on the Companies' Operating Risk

The Companies assert that "the existence or non-existence of the riders do not affect the investor required return" and that neither Staff or CUB-City rebutted this. (NS-PGL IB, p. 87) The Companies further argue that "the riders are risk neutral." The riders would protect shareholders and ratepayers alike from the risk of variations from

[2] Order, Docket No. 03-0403, p. 43, April 13, 2004.

the "normal" assumptions for weather and uncollectibles used for ratemaking purposes." (Id.) The Companies are wrong. Staff witness Kight-Garlisch, CUB-City witness Thomas and GCI witness Brosch all clearly testified that riders would <u>reduce the Companies' risk</u>. (ICC Staff Ex. 6.0, p. 23; CUB-City Ex. 1.0, p. 61; GCI Ex. 1.0, p.) Ms. Kight-Garlisch testified that having a rider in place would reduce the operating risk of the Companies (ICC Staff Ex. 6.0, p. 23), which the Companies acknowledge is a part of investment risk. (North Shore Ex. PRM-1.13A, p. 1 of 3; Peoples Gas Ex. PRM-1.13A, p. 1 of 3) Since investor-required rate of return is lower for investments with less exposure to risk (Id., p. 19), the existence of riders would reduce the investor-required rate of return. (Id., p. 23) Ms. Kight-Garlisch's position is consistent with CUB-City witness Thomas' testimony and GCI witness Brosch's testimony.

CUB-City witness Thomas agreeing with GCI witness Brosch's testimony, testified that the riders would reduce overall operating risk that arise from regulatory lag, or the timing between changes in a Companies' operating income and the inclusion of those items in rate base or revenue requirement. (CUB-City Ex. 1.0, p. 61) GCI witness Brosch testified that: (1) rider ICR can only produce potentially higher prices for customers (2) UBA would shift the risk associated with fluctuating commodity cost bad debt from the Companies to ratepayers, and (3) all the riders "represent management's selection of isolated elements of the revenue requirement calculation, where future changes are expected to have negative consequences to the utility, for piecemeal rate changes that would shift costs and risks to ratepayers. (GCI Ex. MLB-1.0, pp. 21-22) The Companies while acknowledging that "risk …is often defined as the uncertainty of achieving expected performance, and is sometimes viewed as the probability distribution of possible outcomes" (North Shore Ex. PRM 1-13A, page 1 of 3; Peoples Gas Ex. PRM 1-13A, page 1 of 3) still refuse to acknowledge that the riders make it more probable that increases in costs rather than decreased cost will be passed on to ratepayers in the form of higher rates i.e. reduce the Companies' risk.

The Companies also argue that the rates should be increased if the proposed riders are not approved based on the financial parameters of the utility sample. (NS-PGL IB, p. 87) The Companies argument is baseless. Staff points out that currently the Companies are without the riders and have the same level of operating risk as the Gas Sample, which includes companies that have some of the tracking mechanisms the Companies have requested in this proceeding. Therefore, approving some or all the proposed riders would reduce the Companies' operating risk below that of the Gas Sample, which in turn, would further lower the Companies' cost of common equity. The Commission should not approve any of the riders, which would transfer risk from the Companies to ratepayers, without compensation to those ratepayers through lower authorized rates of return. (ICC Staff Ex. 18.0, p. 6)

c. Beta Estimate-Response to Companies

The Companies claim that Staff's regression betas used in its risk premium model are "unnecessary" and "irrelevant to the investor's required return." (NS-PGL IB p. 79) The Companies' argument should be disregarded. The validity of Staff's beta estimation methodology is not a function of whether investors rely upon Staff's beta estimates as the Companies suggest, but rather, the validity of the methodology is a function of whether it is generally accepted. The methodology Staff used to calculate the betas for its sample, which Staff has regularly used and the Commission has consistently approved,[3] employs the same monthly frequency of stock price data as the widely accepted Merrill Lynch methodology. The Value Line methodology is not inherently superior to Staff's methodology. Different beta estimation methodologies can produce different betas when those methodologies employ different samples of stock return data. As Staff witness Kight-Garlisch further testified, the Companies' argument to exclude Staff calculated betas and rely upon only Value Line betas was rejected by the Commission in Docket No. 00-0340.[4] (ICC Staff Ex. 18.0, p. 12)

Value Line and regression betas are estimates of the unobservable true beta, which measures investors' expectations of the quantity of non-diversifiable risk inherent in a security. Consequently, which beta estimates are more accurate is unknown. Further, other sources publish beta estimates for the companies in Staff's Utility Sample that are even lower than the regression beta estimates. For example, the published betas for Staff's Utility Sample from Zacks averaged 0.59 after adjustment and from Reuters averaged 0.60 after adjustment, both of which are lower than the adjusted regression beta of 0.62. The beta estimates from the various sources Staff reviewed are shown in the table below. The disparity in beta estimates does not indicate which beta estimates are superior. (ICC Staff Ex. 18.0, pp. 12-13)

[3] Order, Docket No. 02-0837, October 17, 2003, pp. 37-38; Order, Docket Nos. 02-0798/03-0008/03-0009 Cons., October 22, 2003, p. 85; Order, Docket No. 00-0340, February 15, 2001, p. 25; and Order, Docket No. 03-0403, April 13, 2004, p. 42.

[4] Order, Docket No. 00-0340, February 15, 2001, p. 25.

Table 1

Source	Raw Beta	Adjusted Beta
Zacks	.37	.59
Reuters	.39	.60
Yahoo!	.77	.85

The Commission has accepted the use of Staff regression beta estimates in numerous proceedings,[5] most recently in Docket Nos. 06-0070/06-0071/06-0072 Consolidated.[6]

d. DCF

The Companies argue that three of Staff's DCF results "approached and even fall short of the cost of debt." (NS-PGL IB, p. 75) They continue by claiming such results indicate "that there is something seriously wrong with Ms. Kight-Garlisch's application of the DCF model." (Id.) The Companies arguments are without merit. First, while the DCF cost of common equity estimate for Nicor is below the current yield on A-rated public utility bonds, individual DCF estimates for other sample companies are well-above the yield on A-rated public utility bonds. The only criticism against the other two utilities, WGL Holdings and Laclede Group (ICC Staff Exhibit 18.0, p. 7), in the sample are that they are low (Id.) but the Companies acknowledge that they are not below the cost of debt ("approach … the cost of debt.") (NS-PGL IB, p. 75) The Companies fail to

[5] *See* Order, Docket No. 03-0340, February 15, 2001, p. 25; Order, Docket No. 03-0398, April 7, 2004, pp. 14-16; Order, Docket Nos. 02-0798/03-0008/03-0009 (Cons.), October 22, 2003, p. 85; and Order, Docket No. 03-0403, April 13, 2004, pp. 26-27, 33, and 42.

[6] Order, Docket Nos. 06-0070/06-0071/06-0072 Consolidated, November 21, 2006, p.145.

recognize that the average cost of common equity for the sample used is reasonably above the yield on A-rated utility bonds. (ICC Staff Ex. 18.0, p. 7)

Second, as Staff witness Kight-Garlisch testified Staff's recommendation is based upon a representative sample, rather than any individual company's estimate. Since estimates for a sample as a whole are subject to less measurement error than individual company estimates. Eliminating companies on the basis of their individual DCF results without regard to the effects of such action on the overall sample is improper. That would defeat the purpose of using a sample. In addition, Mr. Moul only looked for companies in the sample with "low" results. That is Mr. Moul only concerned himself with DCF results that lower the recommended cost of equity and was not concerned about high DCF results. Staff's DCF-derived cost of common equity estimates had two companies with results that were more than one standard deviation away from the DCF mean, Nicor and Atmos Energy. The sample selection process is designed to strike a balance between measurement error due to sample composition and measurement error due to individual company cost of common equity estimates. Removing those two companies would reduce the sample to six companies. All else equal, a larger sample better mitigates the potential measurement error of the individual company cost of common equity estimates. Thus, it would be inappropriate to reduce the sample size, given the lack of any demonstrated benefits of the removal of the two companies. (ICC Staff Ex. 18.0, pp. 6-7) However, if the Commission deems it appropriate to remove Nicor and Atmos Energy from the DCF analysis as outliers, the Commission should also remove Nicor from the CAPM analysis since its beta is also more than one standard deviation from the mean sample beta. Removing Nicor from the CAPM analysis would reduce its estimate of the cost of common equity from 11.34% to 10.91%. (Id., p. 8)

e. Other ROEs

The Companies argue that when setting the Companies' rates of return one thing which the Commission should consider is "other rates of return recently allowed for other gas utilities in Illinois and the United States." (NS-PGL IB p. 90) The Companies' witness, Mr. Moul, presented a graphical depiction of the distribution of 54 cost of common equity decisions for electric and gas utilities for 2006 and noted that they demonstrate the inadequacy of Staff's recommendation. (North Shore/Peoples Gas Ex. PRM-2.0, p.4.) However, Mr. Moul failed to specify many critical factors that influenced the allowed returns in those 54 proceedings. For instance, Mr. Moul did not identify the relative risk, as exemplified by credit rating or any other metric, of each of the utilities involved in those return decisions. Nor does he identify the capital structure that was adopted or the amount of the common stock flotation cost adjustment, if any, that was included in each of those decisions. Without such data, any evaluation of the return recommendations in this proceeding via comparison to the returns authorized in the 54 cases Mr. Moul cited is useless, since the Commission has no basis on which to assess comparability. In fact, given the financial strength implied by the Companies' forecasted financial ratios, Staff would expect the Companies' required return on common equity to be considerably lower than average. Quite consistently, Staff's recommendations of 9.5% for North Shore and 9.7% for Peoples Gas fall below the 10.49% average allowed by other regulatory commissions in the U.S. for 2006 that Mr. Moul cites. In contrast, the Companies' return request of 11.06% is above that average. Finally, the

Commission has rejected this type of argument made by the Companies in ComEd's most recent delivery services docket. (Order, Docket No. 05-0597, July 26, 2006, p.153)

f. Response to CUB-City

CUB-City asserts that Ms. Kight-Garlisch's CAPM estimate incorporated "inappropriate inputs" and applied "unlawful applications." (CUB-City IB, p. 46) CUB-City's assertion is with out merit. The main differences between the Staff's and CUB-City's CAPM analysis are their beta and market risk premium. (CUB-City IB, p. 46) Staff's use of an adjusted beta and a current calculated market risk premium is consistent with the methodologies accepted by the Commission in numerous proceedings. (Order, Docket Nos. 06-0070/06-0071/06-0072 Cons., November 21, 2006, pp. 122, 143-145; Order Docket Nos. 05-0071/05-0072, November 8, 2005, pp. 52-53; Order, Docket No. 03-0403, April 13, 2004, pp. 32-33 and 42)

2. North Shore

As indicated above, the arguments for North Shore are presented jointly with the arguments for Peoples Gas.

D. Flotation Costs

The Commission should reject the Companies arguments for flotation costs, including their last minute argument that they are entitled to some flotation costs recovery for previously incurred but unrecovered flotation costs. As the Companies acknowledge in their initial brief, Mr. Moul proposed a "'standard' adjustment for the 'flotation' costs associated with the issuance of new common stock, namely the underwriting discount and company issuance expenses." (NS-PGL IB, p. 93). Therefore, prior to the filing of their initial brief, Mr. Moul's "standard" adjustment was the only support offered by the Companies for a flotation cost adjustment. Now in their Initial Brief, the Companies for the very first time make an alternative argument. They now claim that if the Commission rejects Mr. Moul's general flotation cost adjustment, then the Commission should at least authorize an adjustment that allows the Companies to recover their "unrecovered" flotation costs. (Id.) Both flotation cost arguments should be rejected.

As Staff set forth in its initial brief, the Commission's Order from the Commonwealth Edison Docket No. 94-0065 provides that "The Commission has traditionally approved [flotation cost] adjustments only when the utility anticipates it will issue stock in the test year or when it has been demonstrated that costs incurred prior to the test year have not been recovered previously through rates." (ICC Docket No. 94-0065, Order at 93-94) Staff's initial brief pointed out that (1) Mr. Moul's general flotation cost adjustment is not based on actual flotation cost incurred by the Companies, but rather applies a generalized flotation cost estimate based on a "public offerings of common stocks by gas companies from 2001 to 2005' and (2) the Commission has repeatedly rejected the use of generalized flotation cost adjustments and (3) the Commission rejected a standard flotation adjustment in the Companies' rate cases, Docket Nos. 91-0010 and 91-0586 (Order, Docket No. 91-0010, November 8, 1991, p. 28; Order, Docket No. 91-0010, October 6, 1992, p. 53), respectively for North Shore and Peoples Gas[7]. (Staff IB, pp. 75-76)

[7] North Shore and Peoples Gas both withdrew their request for a flotation cost adjustment in their last rate cases. Docket No. 95-0031, November 8, 1995, p. 32. Docket No. 95-0032, November 8, 1995, p. 40.

The Companies last minute alternative argument that if the Commission rejects Mr. Moul's general flotation cost adjustment, then the Commission should at least authorize an adjustment that allows the Companies to recover their "unrecovered" flotation costs (NSG-PGL IB, p. 93), should be rejected as well since the Companies have failed to provide sufficient supporting documentation that those flotation costs even exit. Given that failure on the Companies' part, they have failed to meet their burden of proof. While North Shore and Peoples Gas rely upon NS Ex. BAJ-1.3 and PGL Ex. BAJ 1.3 (i.e. Schedule D-5) to support their position that they have previously incurred flotation costs which they have not recovered through rates, the Companies have not provided sufficient evidence in the record to support those Schedule D-5s. There is insufficient evidence in the record that on the various dates listed in Schedule D-5 a certain number of shares were issued, at a certain price per share, which resulted in a certain amount of proceeds received for which there were underwriting discounts & commissions along with issuance expenses incurred by the Companies. The Commission has no assurance that the information contained on Schedule D-5 is accurate and reliable since North Shore and Peoples Gas never took the position that they in fact had unrecovered issuance costs. Importantly, the Companies never even showed that a single dollar of the proceeds from the Peoples Energy common stock issuances presented in those exhibits was ever invested in the Companies let alone whether any was used for utility purposes, if they exist, were appropriate. If the Companies had taken this position in their initial testimony then Staff would have analyzed and requested documentation from the Companies to support the schedule D-5s. However, the Companies did not do that. They sought a flotation cost adjustment based upon a standard adjustment. As a result all of the Companies evidence in the record on flotation costs went solely to support Mr. Moul's generalized flotation cost adjustment. The Companies provided no evidence to support the argument that it had past unrecovered issuance costs. The case law is clear that the burden of proof thus rests on the utility to, "prove the reasonableness of the values it places on the components of the revenue requirement," including a "show[ing] that its operating costs are reasonable, [and] its rate base is the reasonable value of its property used for serving the public." (Citizens Util. Bd. v. Illinois Commerce Comm'n, 276 Ill.App.3d, 730, 746, 658 N.E.2d 1194, 1206 (1st Dist. 1995)) Finally, even if one were to accept as true the Companies claim that they incurred flotation costs for the amounts set forth on Schedule D-5, the Companies merely imply that they have not previously recovered their flotation costs through rates, by referencing several past Commission Orders, however Commission has stated that the lack of a reference to recovery of such costs in previous orders is not sufficient evidence to support an adjustment for flotation costs. (Order, Docket No. 91-0193, March 18, 1992, p. 106)

For all of the above reasons, the Commission should not allow the Companies a flotation cost adjustment.

V. HUB SERVICES (All issues relating to Hub services)

A. Peoples Gas Mischaracterizes Staff's Central Argument

The Companies state that, "The essence of Staff's argument is that Peoples Gas should have, but did not, inject more cushion gas to support the Hub operations." (NS-PGL IB, p. 96) Further, the Companies also state that, "Staff argues that the need for a large, expensive cushion gas injection is just around the corner. However, Staff's argument is entirely speculative and is not supported by the evidence." (Id., p. 97-98) Staff clearly stated its position in its initial brief. Staff argued that Manlove Field could not be expanded without significant increases in base gas. In Staff's view, before starting the Hub, Peoples Gas should have expected that it would have to make that investment in base gas at Manlove Field. Then, Peoples Gas would have been able to accurately gauge its total costs to provide Hub Services before it proceeded to offer those services. Given that Peoples Gas did not make the base gas investment, Staff concludes that Peoples Gas is likely to have to invest a significant amount in the future at a time when gas prices are likely to be much higher than they were in prior years, thus costing ratepayers much more.

Peoples Gas completes its mischaracterization of the "essence" of Staff's argument by misstating Staff's position that cushion gas must be allocated between the Hub and ratepayers. (Id., pp. 96-97) Staff never advocated an allocation of Manlove Field costs between the Hub and ratepayers. In fact, Staff argued that the Hub should be subjected to a net benefits test, taking into account the looming liability that the need for a large increase in base gas presents to Peoples Gas. (ICC Staff Exhibit 12.0, Revised, p. 19) For that reason, Staff notes that its net benefits test is neither simplistic nor a test for whether costs are allocated fairly.

B. Peoples Gas Needed to Increase Base Gas in Manlove to Operate the Hub.

Peoples Gas disputes Staffs' conclusion that Hub operations require a significant amount of base gas in order to operate. (NS-PGL IB, pp. 97-98) The vast majority of Peoples Gas' arguments are already thoroughly discussed in Staff's initial brief. In fact, Staff's initial brief, pages 90 through 106, already fully explains that Manlove, like all aquifer storage fields requires base gas to support the working inventory of the field, that the expansion of working inventory to create the Hub immediately created base gas, that Peoples Gas altered the manner it operated the Manlove Field when it initiated Hub service, that the gas within Manlove is continually expanding also creating a need for base gas, as well as Staff's discussion on the likely magnitude of the volume of base gas needed for Hub operations.

While Staff's initial brief addresses many of the claims made in Peoples Gas' initial brief, Peoples Gas has made certain claims that Staff addresses below. In particular, Peoples Gas claimed that less base gas is needed now than in the past because Manlove Field trapped or retained more initial gas injections than subsequent injections, thus relatively less gas was trapped in more recent injections. (NS-PGL IB, pp. 95-96) Staff disagrees.

Peoples Gas' support for its position that Manlove's base gas injection amounts are decreasing (NS-PGL IB, p. 95) is provided by a graph (North Shore/Peoples Exhibit TLP-2.6) that shows a 7-year running average of the additional cushion or base gas added to the field since the field began operation. This graph shows that the percent of total injections into Manlove varied from 1.2% to 6.3%, of the total injections, from 1964 to 2006.

Staff notes that this graph covers a time period with two distinct injection paradigms. First, from 1964 to 1998 cushion gas was injected only when Manlove performance declined, and second, from 1999 to 2006, cushion gas was injected on a continuous basis and recorded as a percentage of volume of the whole-gas injections. Since Peoples Gas employed two completely different cushion gas injection methodologies, any conclusions drawn from the graph are suspect. The only conclusion that Staff could reach from People Gas' graph is that maintenance or base gas requirements for Manlove have and do vary over time and Peoples Gas ' ability to predict its base or maintenance gas needs is questionable. Further, Staff noted that this information did not demonstrate that the maintenance gas needs at Manlove will not increase in the future. (Staff Ex. 22.0 pp. 29-30) Moreover, Peoples Gas' claim that base gas requirements reduce over time is also disputed by its recent need to increase the base gas continuous injection volumes from 2% to 3.5%.

Staff concludes that Peoples Gas' claim is merely an attempt to use technical sleight of hand to confuse the issue of how much base gas is needed to support Hub services, and the graph therefore provides misleading support for the Company's unsupportable position that the expansion of Manlove for Hub services did not immediately require the addition of base gas. Nevertheless, two facts are not in dispute: Staff and Peoples Gas both agree that Manlove initially required base gas to support its working inventory, and that Manlove has historically required the periodic injection of additional base gas because of the continued migration of working inventory to base gas. Thus, Peoples Gas' attempt to demonstrate that Hub operations do not initially require any base gas or its most recent claim that only a small increment of the annual base gas injection volumes should be allocated to Hub operations is erroneous, and cannot be supported in light of the Company's own evidence: Manlove performance declines without the addition of base gas and more base gas is currently necessary to maintain current field operations. Thus, the Company's claims should be rejected.

Peoples Gas also claims that its recent decision to increase the percentage of gas injected in the field for base gas requirements from 2% to 3.5% does not in actuality represent an increase. (NS-PGL IB, p. 97) Peoples Gas now attributes some of the increase from 2% to 3.5% to a metering problem at Manlove caused by pulsations of the compressors. (NS-PGL IB, p. 97; NS-PGL Ex. TLP-2.5) In fact, Peoples Gas speculates that it was likely injecting over 3% instead of the 2% of continuous injections it thought it was making. Peoples Gas also claims (North Shore/Peoples Gas Ex. TLP-2.0, p. 7) that its study indicates that depending on the combination of compressors being used at any one time, the metering could have been understated by 0.1 to 5.3%, therefore, more gas was being injected than was believed at the time. (NS-PGL IB, p. 97)

Staff disputes Peoples Gas' claims. First, if Peoples Gas was truly concerned that more gas was being injected into the field then was measured, it should have corrected those amounts as part of the instant proceeding, but Peoples Gas made no such corrections, to its own detriment. Second, Peoples Gas' stated study results are little more than speculation as to the impact of the apparent metering error on the 2% continuous injection rate since Peoples Gas prior reservoir studies determined that the 2% amount was adequate to support Manlove operations. (ICC Staff Exhibit 22.0, p. 29) Finally, Peoples Gas' own review showed that storage injections could be understated by from 0.1 to 5.3%, meaning the metering issue was either minor or so massive that all of its inventory values should be restated. However, Peoples Gas own actions, or lack thereof with regard to its inventory amounts shows that Peoples Gas' views these amounts as negligible. Therefore, Peoples Gas claims that its decision to increase the percentage of gas retained for base gas injections from 2% to 3.5% was due to metering error is pure speculation and should be treated as such.

C. The reasons given by Peoples Gas for continued provision of Hub Services are insufficient.

Peoples Gas gives three reasons it should be allowed to continue to provide Hub Services. The first reason is that the Hub revenues are credited to the PGA. The other two reasons are claimed indirect benefits. (NS-PGL IB, p. 99) Staff will first address the indirect benefits claimed by Peoples Gas. The first indirect benefit claimed by Peoples Gas is the claim that Hub Services extend the Manlove decline point (NS-PGL's IB, pp. 99-100) which makes the field more valuable, and the second indirect benefit claimed by Peoples Gas is that the Hub adds liquidity to the Chicago gas market and lower gas prices. (NS-PGL's IB, p. 100) In its initial brief, Staff anticipated the decline point argument and set forth that the Commission has already rejected that claim. (ICC Staff IB, p. 106) Staff will respond in this reply brief to the claim that the Hub adds liquidity and lowers gas prices.

Peoples Gas claims that additional liquidity lowers prices: "[i]ncreasing market liquidity by increasing the supply of gas at the Chicago city gate creates downward pressure on gas prices." (NS-PGL IB, p. 100) Staff disagrees with this statement as a compelling reason to allow HUB services to continue. Specifically, Staff notes two hurdles, left unresolved by the Company, in supporting its argument that Hub services create a benefit. For one, it is not clear the extent to which the Hub adds 'liquidity' to the market. Various publications calculated price indices before the Hub was operational, so a market clearly already existed. Two, even if the Hub adds some degree of liquidity to the market, it does not at all necessarily follow that it then lowers prices. The Commission should take notice that the Companies failed to provide a citation to the record to support this statement. It simply arrives out of thin air. The absence of such a claim in the record means that Staff and other parties have never been provided with an opportunity to rebut the claim. Therefore, it is difficult to respond to such a claim in a brief. The best that can be said is that additional liquidity lowers transaction costs, which make the price signal more valuable. But prices themselves are determined by the interaction of supply and demand, and additional liquidity, by itself, does not alter that balance.

Staff concedes that Peoples Gas is crediting revenues that are currently higher than costs being incurred. (NS-PGL IB, p. 102) However, it does not believe that these revenues are sufficient to justify continued Hub operations, since the revenues are overwhelmed by the likely need for massive investments in base gas. (ICC Staff IB, p. 86) This is the correct interpretation of Dr. Rearden's cross, as opposed to the Company's interpretation in its Initial Brief when it states, "[w]hen asked what a net benefit to ratepayers is as it pertains to the Hub, Staff Witness Dr. Rearden's response was, '[r]evenues of – either cost savings or revenues greater than costs" (NS-PGL IB, p. 102) As is evident from the entire body of Dr. Rearden's testimony (ICC Staff Exhibit 12.0 Revised and ICC Staff Exhibit 24.0 Corrected), his statement fully included the costs of base gas that have not been realized to date, but that Staff views as realistically going to be incurred. (Id., p. 31)

In addition, Staff also notes that North Shore and Peoples Gas' initial brief makes some statements that need to be clarified. For example, at page 95, the brief states that "Staff's argument has the feel of a cross-subsidization claim, i.e., that Peoples Gas has not been attributing the right costs to the Hub, thereby somehow compromising the interests of ratepayers." However, Staff does not argue that Peoples Gas should account for the Hub separately from the ratepayers and allocate costs from the ratepayers to the Hub. Staff is only directly concerned with whether ratepayers are better off with the Hub or without it; that is, whether the Hub, including all of its associated costs, is prudent. To this end, Staff conducts a net benefits test. If the result is a negative net benefits (i.e., Hub benefits are less than its costs), then ratepayers are subsidizing Hub customers, since ratepayers are covering costs caused by Hub customers. ,

Staff has pointed out on more than one occasion that Peoples Gas has claimed not to have conducted a prudence test before it began the Hub or expanded the field. (Staff IB, p. 82, 84, and 88) Staff never claims that a certain allocation of costs should be made. (Staff IB, pp. 110-122) Oddly, the Companies state that, "Staff's position is merely an attempt to isolate a part of the integrated utility system as though it were built to serve only Hub services transportation and storage customers and as if the facilities used to serve Hub customers could be separately identified." (NS-PGL IB, p. 95) First, it appears that the Companies are arguing that "the facilities used to serve Hub customers" are costless, whereas Staff showed that significant costs may be impending if the increased Manlove Field working inventory is maintained. (ICC Staff IB, pp. 80-81) Second, Staff notes that it never argued that Peoples Gas should set part of Manlove Field aside for ratepayers and part for Hub Services, but Peoples Gas did allocate the increase in base gas between the Hub and ratepayers. (NS-PGL IB, p. 97 quoting NS-PGL Ex. TLP-2.8) In fact, Staff argues against allocating the amount that Peoples Gas has added to base gas, since Peoples Gas may need to inject up to 36 BCF more into base gas, and the amount injected to date is far below this requirement. Thus, for all these reasons, Staff does not advocate allocating the amount injected so far between the Hub and ratepayers. (ICC Staff IB, p. 111)

D. Staff Does Not Argue that Gas Charge Assets Subsidized the Hub

Peoples Gas states that, "The record is devoid of any evidence that Peoples Gas has utilized any of the gas charge assets to subsidize Hub services." (NS-PGL's Initial Brief, p. 101) However, this misunderstands Staff's point. Staff argues, consistent with the Commission's Order in Docket No. 01-0707, that Peoples Gas uses gas charge assets in order to provide Hub Services. Therefore, by Commission rules, all revenues must be credited to the PGA. (ICC Docket No. 01-0707, Order dated March 28, 2006, pp. 8 and 104)

E. Disallowance is Proper

Peoples Gas argues that Staff's proposed disallowance is improper, because it is not offset by revenues. Peoples Gas alleges that Staff calculated $13.3 million in costs, which is offset by $10-12 million in revenues. Therefore, it concludes that the disallowance should be $1.3 to $3.3 million. (NS-PGL IB, p. 103)

This argument should be rejected. The nature of the $13.3 million cost figure is misunderstood. The figure was calculated as an answer to the following question: what is the annual cost of the base gas and operating expenses in 1998 when Manlove Field's working inventory is expanded by 8 BCF? Another examination of the issue in 2007 found that the annual costs of the base gas and operating expenses due to Manlove Field's working inventory being expanded by 10.2 BCF (taking into account the additional base gas that Peoples Gas has already established) is $32 million (ICC Staff Ex. 24.1)

F. If The Commission Orders Peoples Gas To Stop Offering Hub Services, It Need Not Decide What Peoples Gas Should Do With Its Manlove Field Capacity

City-CUB argues that "…if the Commission determines that Hub services should be terminated, it must also decide the appropriate disposition or use of the 10.2 Bcf of working gas currently assigned to the Hub." (City-CUB IB, p. 53) Staff disagrees. The Commission can conclude that the Hub should be shut down without specifying what should happen to its Manlove Field allocation. The Commission does not proscribe prudent decisions beforehand. Staff believes that Peoples Gas should determine the working inventory that the utilities require and its best use. The Commission should not foreclose any options, but rather must investigate the prudency of decisions actually made. This can be accomplished in PGA proceedings.

G. Staff Agrees With CUB-City That The Amount Of Working Inventory At Manlove Field Devoted To Utility Service Should Not Be Set Before The Utilities Optimize Their Portfolios

CUB-City's main point about the Hub appears to be that Peoples Gas should stop their practice of predetermining a portion of Manlove storage capacity to be used for the Hub before it optimizes its gas supply portfolio. (CUB-City IB, p. 54) Staff agrees that the Manlove Field's working inventory should not be allocated for Hub Services before determining the optimal allocation to ratepayers.

VII. NEW RIDERS

A. Overview

The Companies' overview attempts to portray the use of riders as a routine and unremarkable regulatory device whose use – even for new types of riders -- is beyond reproach. (NS-PGL IB, pp. 108-110) According to the Companies, the concerns raised by Staff and intervenor witnesses regarding the new rider proposals "are simply unavailing in the face of the long standing judicially sanctioned use of rate trackers in Illinois." (*Id*. at 109) The Companies' recital of this long history is limited to a brief mention of the supreme court's seminal opinion holding that the Commission has "the power to authorize an automatic adjustment clause … in the proper case" (*City of Chicago v. Illinois Commerce Comm'n*, 13 Ill. 2d 607, 150 N.E.2d 776 (1958)), and the citation of two Commission orders addressing rider recovery of coal tar clean-up costs for the propositions that riders have been invoked by the Commission on its own initiative and have been used for costs that vary widely and are difficult to predict. (NS-PGL IB at 109) Given the array of significant issues that have been considered by the Commission and the courts with respect to the use of riders – such as the nature and extent of the Commission's authority to approve rider recovery, permissible justifications for rider treatment, application of the prohibitions against single-issue and retroactive ratemaking, application of the Commission's test year rules, and the propriety, scope and necessity of a prudence review under a rider (Staff IB, pp. 123-148) – Staff is somewhat mystified by the Companies' failure to directly address any of these legal issues in a substantive manner in their Initial Brief. The Companies' silence on these relevant legal issues regarding riders is made even more surprising when one considers the rather obvious implication of these issues under the Companies' proposals, as well as the cross examination by Staff and others on factual and policy matters related to these legal issues.[8] (See e.g., Tr. pp. 1552, 1575-1576, 1581, 1591, 1613-1614, 1622-1625)

The Companies' broad generalizations about the acceptance and use of riders (NS-PGL IB, p. 109) fail to acknowledge that the Commission has been very sparing in the exercise of its discretionary authority to approve a rider when justified. Notwithstanding that nearly fifty years have passed since the supreme court first sanctioned riders in *City of Chicago,* the authorized use of riders has, in general, been limited to a small number of very unique and special circumstances:

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[8] The foregoing facts cause Staff to raise a potential procedural issue. While Staff does not know what arguments will be raised by the Companies in their reply brief, Staff is concerned that new arguments addressing legal issues that could have and should have been addressed in the Companies' Initial Brief will be raised for the first time in their reply brief. If this occurs, Staff and Intervenors will be deprived of an opportunity to respond to these arguments and the Administrative Law Judges ("ALJs") will be deprived of the opportunity to consider fully developed arguments in preparing a proposed order. The concept of simultaneous briefing by all parties in Commission proceedings facilitates the development of a full and complete record in an expeditious manner to comply with statutory deadlines, but only when all parties raise material legal arguments supporting their positions in their initial briefs. Indeed, the Commission has recently admonished a litigant that conduct along these lines is not well received and will not be tolerated:

> The Commission first observes that Ameren's Initial Brief on Rehearing did not address the issue of reporting requirements but its Reply Brief on Rehearing fully addressed the issue. Having reviewed Ameren's Reply Brief on Rehearing closely, it is clear to the Commission that Ameren's arguments on this issue, in their entirety, could have been included in Ameren's Initial Brief on Rehearing. The Commission hereby notifies Ameren that the strategy of including arguments in its reply briefs that could have and should have been included in its initial briefs is not viewed favorably. The Commission directs Ameren to cease this practice in future proceedings….

(*In re Central Illinois Light Co. d/b/a AmerenCILCO, et al.*, ICC Docket No. 06-0070/06-0071/06-0072 (Cons.), p. 35 (Order on Rehearing May 16, 2007)) While Staff cannot know now what arguments the Companies will raise in their reply brief, the Companies' failure to make any attempt to address obvious legal issues in their Initial Brief seems to raise the possibility that such conduct could occur. If inappropriate conduct is observed, Staff respectfully requests that the Commission send an equally strong message that such a strategy will not be tolerated and take such action as it deems appropriate.

- Recovery of purchased gas, fuel, power expenses. (*See City of Chicago v. Illinois Commerce Comm'n*, 13 Ill. 2d 607, 150 N.E.2d 776 (1958) (authorizing rider recovery for the cost of purchased gas); 220 ILCS 5/9-220 (authorizing adjustment clauses for recovery of purchased gas, fuel and power); *United Cities Gas Co. v. Illinois Commerce Comm'n*, 163 Ill. 2d 1 (1994) (upholding refund order under purchased gas adjustment clause); *Business & Professional People for Public Interest v. Illinois Commerce Comm'n*, 171 Ill. App. 3d 948 (1st Dist. 1988) (upholding refund order under uniform fuel adjustment clause))

- Recovery of statutorily mandated environmental clean-up expenses (*Central Ill. Light Co. v. Illinois Commerce Comm'n*, 255 Ill. App. 3d 876 (3rd Dist. 1993), *affirmed in part and reversed in part*, *Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111 (1995) (upholding approval of a rider to recover coal tar clean-up expenditures for costs associated with cleaning up environmental contaminants resulting from former manufactured gas plant operations))

- Recovery on a localized basis of franchise fees and expenses for non-standard service requirements imposed by local governments (*City of Chicago v. Illinois Commerce Comm'n*, 264 Ill. App. 3d 403 (1st Dist. 1993) (affirming approval of rider for recovery of "the marginal costs of providing 'non-standard' service from customers within any governmental unit that mandates such service"); *City of Chicago v. Illinois Commerce Comm'n*, 281 Ill. App. 3d 617 (1st Dist. 1996) (affirming order providing for localized recovery of franchise fees to remedy unfair distribution of such costs))

- Recovery of expenses for asbestos related liability claims (*In re Illinois Power Co., et al.*, Docket No. 04-0294, p. 50 (Order Sept. 22, 2004) (While specifically indicating approval limited to specific facts and not to be construed as indication of appropriateness of rider recovery in future cases, approved rider to recover expenses for asbestos related liability pursuant to a settlement agreement where rider facilitated sharing of expenses by shareholders (through creation of $20 million fund to pay claims and further sharing after exhaustion of fund) and would only work to pass through expenses (due to operation of fund) if asbestos related liability expenses turn out to be large and volatile))

There have also been riders for certain water and sewer company expenses and costs, and nuclear power plant decommissioning expenses, but such riders were specifically authorized by the legislature and were not approved under the Commission's general Section 9-201 authority. (*See* 220 ILCS 5/9-220.2 and 220 ILCS 5/9-201.5)

As discussed in Staff's Initial Brief, the Commission's decision to authorize rider recovery of expenses and lost profits associated with demand-side management ("DSM") programs was rejected by the courts in *A. Finkl & Sons Co. v. Illinois Commerce Comm'n*, 250 Ill. App. 3d 317 (1st Dist. 1993). Further, the Commission itself has declined to authorize rider recovery of commodity-related uncollectible expenses, finding such expenses "do not warrant special recovery through a rider." (*In re Northern Illinois Gas Co.*, Docket No. 04-0779, p. 181 (Order Sept. 20, 2005))

While Staff certainly agrees that the Commission is authorized under the PUA to approve riders where justified, such authority is an exception to the general requirement to establish specific rates in a base rate proceeding utilizing test year principles. The Companies' rider proposals totally disregard the precedent establishing the framework for exercise of the Commission's discretionary authority to approve rider recovery when warranted, and their asserted justifications for rider recovery fall short. The deficiencies in the Companies' arguments stem, in large part, from their failure to understand or acknowledge relevant Illinois case law and regulatory principles.

B. Rider VBA and Rider WNA

The Companies do not state any compelling reasons why Rider VBA and WNA should be approved by the Commission. Nor do they meet their burden of proof in establishing that the proposed rates are "just and reasonable." (220 ILCS 5/9-201(c)) In fact, the Companies' stated purposes are contrary to the case law addressing rider recovery, and should therefore not be approved.

1. Rider VBA is not consistent with case law

The Companies stated purpose for implementation of Rider VBA, to remove both their incentive to increase sales and disincentive to encourage energy efficiency (NS-PGL IB p. 110), is against all legal tenants developed in rider recovery case law. As discussed in Staff's Initial Brief, Rider VBA does not pass legal muster because it violates the rules against retroactive and single-issue ratemaking, and improperly relies on incentives as justification for rider recovery. (*See Staff IB,* pp. 166-169) As also previously discussed in Staff's Initial Brief, recovery of unexpected, volatile, and fluctuating expenses of a substantial magnitude have been found to justify rider recovery. (Staff IB, p. 170; *Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111, 138-139 (1995)) Neither the Companies' Initial Brief nor their testimonies overcome these legal hurdles. First, the Companies have not addressed how proposed Riders VBA and WNA hold up to judicial scrutiny under the above stated standards. Thus, Staff stands on its arguments put forward in its Initial Brief. (Staff IB, pp. 166-170) The Companies did, however, concede in their overview of the new riders that Rider VBA, a decoupling mechanism, is a revenue assurance mechanism (NS-PGL IB, p. 110); therefore, Rider VBA is not a cost recovery mechanism and is not supported by the case law finding that rider recovery can be justified for the recovery of specific costs that are subject to substantial volatility and unpredictability.

Second, the Companies have claimed that Rider VBA must be approved to give the Companies an incentive to promote energy efficiency, or else the Companies will be "penalized for proposing the energy efficiency program." (NS-PGL IB, p. 115) In exact contradiction, the courts have held that such an incentive-based rider justification is not appropriate under the PUA. (*Illinois Bell Tel. Co. v. Illinois Commerce Comm'n*, 203 Ill.

App. 3d 424 (2nd Dist. 1990) ("*Bell*"); *A. Finkl & Sons Co. v. Illinois Commerce Comm'n*, 250 Ill. App. 3d 317 (1st Dist. 1993) ("*Finkl*")) The holdings in *Bell* and *Finkl* established that the Commission does not have general authority under the PUA to implement incentive based regulation, and therefore cannot rely on incentives to justify exercise of its discretionary authority to permit rider recovery in a proper case. (*Finkl*, at 327-328)

Staff notes that in 1997, following the decisions in *Bell* and *Finkl*, the Illinois legislature passed into law Public Act 90-561, which rewrote Section 9-244 of the PUA to authorize the Commission to implement alternative incentive-based rate regulation in certain well defined circumstances. (*See* 220 ILCS 5/9-244) The Companies have not asserted at any time in this proceeding that Rider VBA or Rider WNA are proposed pursuant to Section 9-244, and such riders do not fit within the specific authority provided therein for alternative incentive-based rate regulation. Moreover, the holdings in *Bell* and *Finkl* that the Commission lacks general authority to implement incentive-based regulation and may not rely on the provision of incentives to justify rider recovery continue to apply -- notwithstanding the specific incentive-based alternative rate regulation authorized by the amendment of Section 9-244 -- under the well established principle of statutory construction that "an amendatory act is to be interpreted as continuing in effect (as previously judicially construed) the unchanged portions thereof." (*People v. Laboud*, ,122 Ill. 2d 50, 55 (1988); *see also Union Electric Co. v. Illinois Commerce Comm'n*, 77 Ill. 2d 364, 380 (1979) ("It is well established that the reenactment of a statute which has been judicially construed is in effect an adoption of that construction by the legislature unless a contrary intent appears.")) Here, Section 9-244 provides authority to implement alternative incentive-based rate regulation in specific limited circumstances, but nowhere indicates an intent to establish that the Commission has a general authority to implement incentive-based regulation.

2. The Companies have not met their burden of proof that the proposed rates are just and reasonable

Section 9-201 of the PUA places the burden of proof on a utility to demonstrate that its proposed rates are just and reasonable. (220 ILCS 5/9201(c)) The Companies offer no legal analysis which supports rider recovery under any of their nebulous justifications. (*See generally* NS-PGL IB pp. 108-110) First, the Companies do not address the prohibitions against single-issue ratemaking, retroactive ratemaking, or incentive-based rider recovery. Second, the Companies offer the statement that rider recovery is permissible in appropriate cases, but do not demonstrate how Rider VBA and WNA meet that standard under the PUA and the Illinois court cases cited in Staff's Brief. (*Id.* and Staff IB, pp. 124-152) Establishing that riders are a possible tool for the Commission does not establish that the proposed riders are permissible or appropriate in this case. Moreover, the First District Appellate Court held in *Citizens Utility Bd. v. Illinois Commerce* Comm'n, 276 Ill.App.3d 730, 747 (1st Dist. 1995), that "requiring intervenors to establish unreasonableness is no substitute for requiring proof of reasonableness." Thus, absent proof from the Companies that the proposed riders (VBA, WNA, ICR, UBA, and EEP) result in just and reasonable rates, they cannot be found to produce just and reasonable rates.

For example, in regard to Rider VBA (and WNA, as the Companies make much the same arguments in their alternative revenue decoupling rider) the Companies claim at several points in their Initial Brief that global warming and energy dependence on foreign imports are reasons to consider revenue-decoupling mechanisms. (NS-PGL IB pp. 111, 113) To the detriment of the Companies' argument, there has been no evidence or testimony offered thus far that supports the notion that global warming and foreign dependence on energy sources translate into a need for Rider VBA or WNA. The Companies make no citation to any such references when discussing global warming and foreign energy over-dependence. Such anecdotal arguments employing current political and social buzzwords miss the mark and amount to nothing more than a convenient method of disguising the real issue: rider recovery of lost revenues is inherently against the body of rider recovery case law, and the Companies have no supporting arguments. (*See* Staff IB, pp. 166-170)

Instead, the Companies attempt more public policy arguments that, while insufficient to overcome the legal hurdles, do not stand on their own. Peoples Gas and North Shore contend that "[t]he purpose of the proposed rider is to remove both the incentive utilities have to increase sales and the disincentive utilities have to encourage energy efficiency for its [sic] customers." (NS-PGL IB, p. 110) The problem with this policy argument is that Peoples Gas and North Shore have failed to establish why they need further incentives to motivate ratepayers to conserve.

In fact, ratepayers have amply demonstrated in recent years that they can conserve very effectively on their own. Companies witness Borgard documents a steep decline in throughput on the Peoples Gas system over recent years. He notes that throughput on the Peoples Gas system fell from the 1996 level of 235.7 bcf projected in the Company's 1995 rate case down to a 2006 normalized level of 177.6 bcf. According to Mr. Borgard, this represents a reduction of 58 bcf or 25% over the 10 year period. (Peoples Gas Ex. LTB-1.0 p. 10, lines 208-213) Mr. Borgard indicated that average annual use by residential heating customers declined by 29% from 160 to 113 dekatherms over the last decade (Id. Peoples Gas at 16, line 353) and small residential heating customer use for North Shore declined by 16% from 159 to 133 dekatherms over the same 10 year period. (North Shore Ex. LTB-1.0, p. 14-15, lines 313-315) The evidence demonstrates that ratepayers are highly motivated to conserve and do not require any additional assistance from the Companies to reduce consumption. Ratepayers certainly do not need a transformation in the regulatory paradigm to provide the Companies with incentives to facilitate their conservation efforts. (ICC Staff Ex.8.0, pp. 15-16, lines 339-352)

Furthermore, Peoples Gas and North Shore have failed to demonstrate that they could even play an effective role in motivating ratepayers to conserve if given the proper incentives. The current incentive for Peoples Gas and North Shore is to encourage more usage by ratepayers. As Mr. Feingold acknowledges, "[t]he "Throughput Incentive" encourages a utility such as Peoples Gas to be financially motivated to increase sales of natural gas (relative to historical levels which underlie base rates) and to maximize the "throughput" of natural gas across its utility system." (Peoples Gas Ex. RAF-1.0, p. 23, lines 455-458 and North Shore Ex. RAF-1.0, p. 21, lines 457-460) Despite this incentive, the Companies could not prevent ratepayers from significantly reducing their gas consumption over the past twelve years. If Peoples Gas and North Shore were unable to induce ratepayers to consume more before, it is not clear why they will be able to motivate ratepayers to use less in the future. (ICC Staff Ex.8.0, p. 16, lines 366-368)

Two additional considerations call into question whether the Companies' ratemaking proposals are motivated by concerns about energy efficiency and conservation. Rider WNA, the Companies alternative proposal in the event the Commission was to reject Rider VBA, would maintain the Companies' current disincentive to promote conservation. Because Rider WNA adjusts revenues on the basis of weather only, the Companies would have the incentive to encourage increased consumption, rather than conservation. The fact that the Companies would be willing to replace Rider VBA with Rider WNA raises questions about the depth of their commitment to conservation.

The second consideration comes from the Companies' proposed rate design in this case; specifically, their proposal to recover a greater share of revenues from fixed customer charges and less from volumetric charges. This increase in customer charges undermines ratepayer efforts to conserve by lowering the potential cost savings that result from less consumption. (ICC Staff Ex. 20.0, p. 8, lines 156-167) If the Companies were truly concerned about conservation, they would have done the opposite by raising volumetric charges and lowering customer charges.

In addition, the Companies' case for Rider WNA presents its own problems as well. Rider WNA, like Rider VBA, promotes the interests of the Companies at the expense of ratepayers. Like Rider VBA, Rider WNA asks ratepayers to pay a price for stabilizing the revenues flowing to Peoples Gas and North Shore. Furthermore, according to the Companies' own testimony, Rider WNA will serve as a revenue enhancing tool. The proposed rider will adjust revenues according to the relationship of temperatures in future years to temperatures for the months of October 2005 through

May 2006. Companies witness Tackle testifies that the number of Heating Degree Days (HDD) should rise on an overall basis over the next six to ten years. (Peoples Gas Ex. EST-1.0, p. 2, lines 25-28) If that were to happen, then the Companies would enjoy an upward adjustment in revenues overall due to Rider WNA over this time period. Thus, based on the forecast of Companies witness Tackle, Peoples Gas and North Shore will receive greater revenues and ratepayers will pay higher gas bills as a result of Rider WNA. (ICC Staff Ex.20.0, pp. 31-32, lines 713-722)

Moreover, as with Rider VBA, Peoples Gas and North Shore have failed to justify Rider WNA from a business standpoint. As previously noted, the Companies have demonstrated an ability to operate successfully within the confines of the traditional regulatory paradigm. They have been able to avoid filing a new rate case for a full 12 years and have earned rates of return at or above their authorized levels for a number of years within this period. In addition, they are requesting a ten-year weather normalization period which Staff does not oppose. (ICC Staff Ex.20.0, p. 32, lines 725-731) These factors demonstrate the Companies can operate successfully without the assistance of Riders WNA and VBA.

3. Other regulatory commissions have not approved similar riders

The Companies also claim that the business challenges of no longer expecting sales to just increase, while usage decreases and consumer costs of gas increase, is a new reality. (NS-PGL IB, p. 111) In the face of overwhelming evidence that these "new realities" have existed for quite some time and are not new, the Companies' only refuge is the argument that other state public utility commissions have approved decoupling-mechanisms. (*Id.*) The argument that other public utility commissions have approved certain riders in no way establishes the authority of the Commission to approve such riders under Illinois law. Further, review of the cases cited by the Companies demonstrates that the Companies' lack of discussion masks that even those commissions approving some form of decoupling have done so with reservations, concerns and limitations.

The Companies cite *Re Northwest Natural Gas Co.*, 245 P.U.R. 4th 165, 2005 Ore. PUC LEXIS 403, Aug. 25, 2005, Docket No. 05-934, a decision of the Oregon Public Utility Commission, in connection with their assertion that revenue decoupling mechanisms 1) do not shift risk to customers; 2) do not create negative incentives toward customer services; 3) reduce a utility's disincentive towards energy efficiency; and 4) improve the utility's ability to recover fixed costs. (*See* NS-PGL IB at 114) However, the Companies fail to state that the Christensen report, paid for by the utility, was not made a part of, cited by, or discussed by the Oregon Commission in its Order. (*See generally Re Northwest Natural Gas Co.,* 245 P.U.R. 4th 165) Companies witness Feingold asserts, in his rebuttal testimony, that the "results of the [Christensen] report gave rise to NW [Northwest] Natural [Gas Co.] receiving regulatory approval in August 2005 to extend operation of its revenue decoupling mechanism for an additional four years." (North Shore/Peoples Ex. RAF-2.0, at 46) In fact, the approval came through a stipulation adopted by the parties and approved by the commission as "an appropriate resolution of all issues," based on a finding that "adoption of the stipulation is in the public interest." (*Re Northwest Natural Gas Co.,* 245 P.U.R. 4th 165. at 5) The Oregon Commission did not discuss or adopt the findings of the report. (*Id.*) Nor is there any evidence to indicate that the report persuaded any parties, let alone the Oregon

Commission, in their decision to continue use of the revenue decoupling mechanism—as the Stipulation does not mention the Christensen report at all. (*Re Northwest Natural Gas Co.,* 245 P.U.R. 4th 165*.* at Appendix A--Stipulation)

Further, the stipulation only extended a revenue decoupling mechanism for four more years, after it had been in place for three years. (*Id.* at 6-7) The Oregon Commission thus labeled the mechanism a "partial-decoupling" mechanism. (*Id.* at 1) Finally, neither the stipulation nor the body of the order found or even discussed the four points that North Shore and Peoples Gas chose to highlight. Thus, *Northwest Natural* in no way demonstrates that the Oregon Commission approved a revenue decoupling mechanisms under the contested circumstances of the instant case. At best it can be stated that the Oregon Commission approved a settlement for a second trial period of a partial decoupling mechanism, without specifically ruling on the merits of the mechanism.

Moreover, Staff highlighted in its Initial Brief a number of state utility commission decisions that demonstrate that few if any states have approved a decoupling mechanisms as broad and as over-reaching as Rider VBA and WNA. (*See* Staff IB, pp. 177-180) Most of those decisions severely limited the recovery methods and amounts, with almost all of those decisions only allowing decoupling to be initiated as a pilot program with a thorough review in just a few years. (*Id.*) The Companies in the instant proceeding have not proposed, and the Intervenors and Staff have not accepted, any settlement, test, trial, or reduced methods of implementing a revenue decoupling mechanism. Thus, the Companies' comparisons to other states is at best an apples to oranges comparison, and provides no real support or foundation for the authority to implement decoupling in Illinois.

The Companies use several other utility commission decisions to support rider VBA, yet they do not discuss a single order. Some of the cited orders either do not have anything to do with revenue decoupling mechanisms, or the mechanisms approved are too far afield from those proposed in the instant case to make the comparison relevant.

For example, Staff notes that the Companies have provided an incorrect citation to *Re: Southwest Gas Corp.* 232 P.U.R. 4th 353 (Cal. P.U.C. Mar. 16, 2004) (NS-PGL IB, p. 116), since no case begins at that citation and the case reported at 232 P.U.R.4th 346 is a Rhode Island Public Utilities Commission case. In addition, *Re New Jersey Natural Gas Co.* is not a case regarding revenue decoupling at all, just an initial order where the commission consented to a stipulation for rate reduction be turned over to the state's Office of Administrative Law. ((N.J.B.P.U. Sept. 29, 2006) (Docket No. GR060604-15) p. 6) (a copy of which is attached to Staff's Reply Brief as Attachment A)

Moreover, the Companies claim that the five orders from other states demonstrate the following benefits of revenue decoupling riders: 1) that risk is not shifted to the ratepayers; 2) environmental and national interest objectives are addressed; 3) the Companies "would recover the portion of the revenue requirement established in this case that is allocated to volumetric charges, no more, no less"; 4) "Rider VBA would incorporate realistic gas volume levels for computing the Utilities' unit delivery rates by utilizing actual volume experience in the monthly rate adjustments; 5) "Rider VBA would be a more effective ratemaking method to address margin volatility and would enable the Utilities to promote energy conservation and efficiency programs without the continual threat of margin losses due to declining gas sales per customer; and 6) without Rider VBA the Companies cannot recover lost revenue requirement from the energy efficiency program that may be establish. (NS-PGL IB, pp. 113-116)

However, the supporting cases offered by the Companies do not relate to the instant proceeding in a meaningful manner. Instead, the cases reveal a similar pattern of *quid pro quo* stipulation agreements without a discussion of the merits of the program, no findings by the commissions, and more often than not involve a pilot program with restrictions on the utility's remuneration. Specifically, *Re Conservation Enabling Tariff Adjustment Option and Accounting Orders*, is a restricted revenue decoupling program approved for three years, with a one year review, coinciding with a rate reduction. ((Utah P.S.C. Jan 16, 2007) (Docket No. 05-057-T01) p. 6) The program was also noted as having "significant limitations" on the monetary recovery by the utility. (*Id.* at 7)

Re Indiana Gas Co., Inc. is also the result of a settlement agreement creating a pilot program. ((Ind. U.R.C. Dec. 1, 2006) (Case No. 42943) (2006 Ind. PUC Lexis 376) pp. 32-33) It is crucial to note that the settlement agreement, and the order accepting the settlement agreement, spell out the terms by which the parties where able to agree. (*Id.*) Specifically, a compromise was reached where the utility would establish its:

> commitment to robust energy efficiency programs that exceed its own prior programs and those of any other Indiana utility [as] the quid pro quo for the OUCC's [Indiana Office of Utility Consumer Counselor] agreement to "pilot" this cost recovery mechanism. The Settlement expresses the Settling Parties commitment to the long-term success of energy efficiency efforts in Indiana and dedication to providing leadership to create in-state expertise and resources that will provide support for ongoing energy efficiency efforts on behalf of all Indiana gas utility customers.

> Vectren Energy will direct all of its employees to advocate energy efficiency to all of its customers and provide employee training to complement the activities undertaken through the Program. Vectren Energy's efforts to complement the Program by proactively encouraging cost effective energy efficiency shall be subject to annual review by the Oversight Board. The Oversight Board will be responsible for monitoring the progress and effectiveness of the ongoing Program, and for making key decisions with respect to the direction of the Program and the use of Program funding.

(*Id.* at 34-35)

Lastly, *Re Cascade Natural Gas Corp. (*(WA U.T.C. Aug. 16th, 2007) (Docket No. UG-060256)), is also an order adopting a restricted partial revenue-decoupling pilot program conditioned on the commission's acceptance of the utility's Conservation Plan with an earnings cap and penalties for missing conservation benchmarks. (*Id.* at 1) Cascade Natural cannot extend the program beyond its three year inception without submitting itself to a general rate case. (*Id.* at 24)

When the Companies' claims of support by other public utility commissions for decoupling are subjected to any scrutiny, that so-called support loses much of its luster. Many states that have approved revenue-decoupling mechanisms have only done so on an experimental basis. The Companies have not demonstrated otherwise, nor have they discussed or supported why Rider VBA and WNA should be approved. In essence, the few revenue-decoupling riders approved by other states are significantly different from the North Shore and Peoples Gas' proposed riders—Rider VBA and Rider WNA do not expire, they are not reviewed, they have no limits, and there is no *quid pro quo* from a settlement.

Thus, Rider VBA and Rider WNA have been proposed, but have not been supported. As revenue recovery riders they can find no safe harbor under the cases holding that rider recovery may be permissible to address volatile, fluctuating, or unpredictable costs—they are, as admitted, not recouping costs. (NS-PGL IB, p. 110) As explained in Staff's Initial Brief, the Companies' proposals are contrary to the rules against single-issue ratemaking and retroactive ratemaking, and impermissibly rely on incentives to justify rider recovery. (Staff IB, pp. 166-170) Thus, the Commission should reject the proposed riders.

4. Rider VBA and WNA increase revenue and financial stability by shifting risk onto ratepayers

The goal of traditional ratemaking is to establish rates that would naturally develop under normal competitive forces. (*State Public Utilities Comm'n v. Springfield Gas & Electric Co.,* 291 Ill. 209, 218, 125 N.E. 891, 896 (1919); *Ill. Power Co. v. Ill. Commerce Comm'n*, 339 Ill. App. 3d 425, 434 (1st Dist. 2003)) The assurance of revenue recovery offered by rider VBA and WNA would eliminate any pretense of natural and normal prices close to a competitive environment.

Thus, the Companies argument that Rider VBA will not entail any shift of risk to customers it is a red herring because it does not guarantee any specific financial performance. (NS-PGL IB, p. 116) While Rider VBA was carefully crafted to avoid using a reference to an earned rate of return, it is simply wrong to argue that Rider VBA does not guarantee any specific financial performance. As explained in Staff's Initial Brief, Rider VBA guarantees a particular level of revenue per customer that is based on the Companies' approved rate of return on rate base. (Staff IB, p. 167) To then claim that Rider VBA does not guarantee any specific financial performance is, at best, the elevation of semantics over substance and, at worst, rather misleading. The fact of the matter is that all businesses are subject to the risk that the prices charged for their goods may not, on a going forward basis, generate the revenues that were anticipated.

The Companies' Rider VBA proposal very clearly transfers the utility's risk of insufficient revenues to customers. The fact that Rider VBA also transfers the risk that rates will generate surplus revenues from the customers to the utility does not mean that risks have not been transferred. Moreover, the evidence presented by the Companies shows that the risk of under-recovering revenues is not as likely to occur given the propensity of customers to control their demand in light of rising gas prices. As such, even if these risks are offsetting via the Rider VBA mechanism, the relative difference in probabilities remain, undermining the assertion that Rider VBA does not transfer risks to customers.

Lastly, as noted in Staff's Initial Brief, several states that have approved revenue decoupling methods have done so with the finding that such riders *do* shift risk to the ratepayers, and have thus limited the effect and breadth of the mechanism to share the risk with the utility. (Staff IB, pp. 177-178)

C. Rider ICR

1. Overview

Peoples Gas indicates that it is "proposing to accelerate the pace" at which cast iron and ductile iron ("CI/DI") main is replaced **if** its proposal to recover the cost of this accelerated capital investment through Rider ICR[9] is approved. (NS-PGL IB, p. 121)

[9] As noted in its initial brief, Peoples Gas' original proposal was termed "Rider ICR". (*Id*., p. 121, fn. 22) While Staff opposes approval of Rider ICR, Staff presented certain modifications in a revised rider, named Rider QIP, to improve the rider and address certain concerns should the Commission decide it is appropriate to allow rider recovery . (Staff Exhibit 1.0, Attachment A) The Company indicates that it does not oppose renaming the rider to "Rider QIP" as proposed by Staff. (NS-PGL IB, p. 121, fn. 22) The Company also accepted certain of the modifications proposed by Staff and others. (*See* ALJ Ex. 1) Staff will refer to the original proposal as "original Rider ICR" or "original Rider ICR proposal", and the modified Rider ICR as "modified Rider ICR" or "Rider ICR" or "Rider QIP". Staff continues to oppose both original Rider ICR and modified Rider ICR.

The Company supports its proposal for rider recovery of rate base costs[10] through Rider ICR based on certain alleged financial and operational benefits. The benefits offered by Peoples Gas to support Rider ICR do not flow directly from Rider ICR. Instead, the claimed "benefits" relate to the acceleration of Peoples Gas' CI/DI main replacement program. The link between Rider ICR and the accelerated CI/DI main replacement program is Peoples Gas' aversion to implementation of the proposed acceleration without Rider ICR due to the negative financial consequences it claims will result under traditional regulation. As will be discussed below, this claim is unsubstantiated and not supported factually or legally.

As was explained in Staff's Initial Brief and will be explained in more detail below, the justifications offered by Peoples Gas for the single-issue treatment of CI/DI replacement costs under Rider ICR are inadequate and flawed. Rider ICR constitutes impermissible single-issue ratemaking, and improperly bases rider recovery on providing an incentive for the Company to accelerate its CI/DI main replacement program. The use of a rider to recover discretionary rate base expenditures under the facts of this case is simply improper under Illinois law, and should be rejected by the Commission. However, if the Commission determines that rider recovery of CI/DI main replacement costs is appropriate, the modifications proposed by Staff in Rider QIP are necessary and should be adopted.

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[10] Rider ICR would also recover depreciation expense related to the qualifying rate base assets, which is an operating expense. (*See* ALJ Exhibit 1, pp. 1, 4-7)

2. Benefits of the Accelerated Program

As noted above, Peoples Gas relies upon benefits of the accelerated CI/DI replacement program to justify Rider ICR. While the Company relies upon the benefits of increasing its CI/DI main replacement program to justify approval of Rider ICR, and expresses its intent to roughly double the pace of its CI/DI main replacement program (Tr., pp. 1541-1542), it makes no firm commitment to actually increase the amount of investment in its CI/DI main replacement program. Rather, the Company retains the discretion under Rider ICR to increase CI/DI replacement as it sees fit. (Tr., pp. 1617-1618) Staff submits that such discretionary and avoidable expenditures are not the type of costs that would generally warrant or justify special rider recovery.

a. The Company Fails To Provide Any Legal Support For Its Novel Proposal

Peoples Gas' Initial Brief fails to address the fact that the Commission and the courts have not previously approved or sanctioned riders for the recovery of a return of and on rate base expenditures under Section 9-201 of the PUA.[11] (See Staff IB, pp. 153, 190) The riders found by the courts to fall within the Commission's discretionary Section 9-201 authority have all involved the recovery of operating expenses rather than the recovery of a return of and on rate base expenditures.[12] (See Staff IB, pp. 127-148)

[11] Rider recovery of a return of and on rate base expenditures has only occurred pursuant to the specific legislative authorization provided in Section 9-220.2 for rider recovery by a water or sewer utility of "costs associated with an investment in qualifying infrastructure plant" subject to an annual prudence review. (220 ILCS 5/9-220.2)

[12] In *City of Chicago v. Illinois Commerce Comm'n*, 264 Ill. App. 3d 403 (1st Dist. 1993) the court affirmed a Commission order approving with modification Commonwealth Edison Company's ("ComEd") proposed Rider 28 – Local Government Compliance Costs, which rider provided for recovery of "the marginal costs of providing 'non-standard' service from customers within any governmental unit that mandates such service." (*Id*. at 404) While the marginal costs involved with Rider 28 could arguably impact rate base costs (e.g., requiring buried power lines), Rider (continued…)

As explained in Staff's Initial Brief, the revenue requirement formula used to set rates in Illinois consists of operating expenses plus a return on rate base. (*Id*. at 125) As explained below, the proposal for rider recovery of a return on rate base through Rider ICR raises additional issues that do not exists in connection with rider recovery of operating expenses.[13]

The Commission has long held that one of the factors that weigh in favor of justifying rider recovery is whether the costs at issue are beyond the control of the utility. (*In re Adoption of Uniform Fuel Adjustment Clause(s)*, Docket No. 78-0457, 1981 Ill. PUC LEXIS 7, p. 7 (Order, Nov. 10, 1981) ("The categories of costs to be passed through the FAC are those that are for the most part beyond the control of the utility ….")) As noted in Staff's Initial Brief, various courts have held that rider recovery may be appropriate when a utility is faced with unexpected, volatile, and fluctuating expenses. (Staff IB, pp. 134, 140-141, 145, 147, 150-152) If a utility has control over when and if an expense is incurred, as would be the case for discretionary costs not beyond its control, it would be difficult if not impossible to satisfy the unexpected, volatile, and fluctuating expense standard for rider recovery. Thus, discretionary capital expenditures would not fall within the "unexpected, volatile, and fluctuating expense"

(continued from previous page)

28 treats the marginal cost difference as an expense and was not reported to involve a return on or of rate base. (*Id*. at 405-406)

[13] Staff also observes that Section 9-211 of the PUA requires that "in any determination of rates or charges, [the Commission] shall include in a utility's rate base only the value of such investment which is both prudently incurred and used and useful in providing service to public utility customers." (220 ILCS 5/9-211) Thus, in addition to the items discussed below, a rider for the recovery of a return on rate base requires a determination that such investments were prudently incurred and used and useful.

rider justification that has been accepted by the courts because (1) such expenditures are not operating expenses and (2) such expenditures would not be properly considered to be unexpected, volatile and fluctuating.

Similarly, in approving rider recovery of certain operating expenses, the courts have focused on the fact that the riders in question provided for the direct recovery of a particular cost without direct impact on the utility's rate of return. (Staff IB, pp. 141, 148, 150-152) That same analysis does not hold true for rider recovery of a rate of return on new rate base expenditures. First, as indicated by the revenue requirement formula, rate of return has no impact whatsoever on operating expenses. In contrast, allowing rider recovery for a return on additional rate base investment directly implicates the rate of return portion of the formula. Second, relying on the rate of return authorized in a prior rate case departs from the practice of basing rider recoveries (at least at the reconciliation phase) on actual costs. (*See UFAC Order*, p. 6) An appropriate rate of return depends on many time sensitive factors, and it cannot be said that a rate of return established for a utility one or more years ago is an appropriate rate of return for that utility today. Thus, even if one considers a rate of return to be a cost, a rider recovery mechanism for a return on capital expenditures that relies on a previously established rate of return cannot be found to be just and reasonable since it avoids any determination of an appropriate rate of return (or cost) at the time of assessing costs under the rider.

Finally, absent specific legislative authorization, a proposal to recover a return on additional capital expenditures through a rider goes beyond the Commission’s judicially recognized discretionary authority to approve rider recovery as an alternative to base rate recovery in appropriate circumstances; and instead ventures into independent single issue ratemaking. In deciding whether rider recovery of operating expenses is warranted, the Commission is deciding whether the expense should be recovered through base rates or through a rider. If the expense is recovered through a rider, it is removed from base rates – and vice versa. This symmetry has been a critical component of the reasoning supporting a finding that rider recovery of expenses does not violate the prohibition against single-issue ratemaking. In *City of Chicago v. Illinois Commerce Comm'n*, 281 Ill. App. 3d 617 (1st Dist. 1996) the court acknowledged that riders must be closely scrutinized because of the danger of single-issue ratemaking, but concluded that the dangers of single-issue ratemaking were not present since the Commission merely removed an expense from base rates and instead provided for its recovery through a rider:

> The proposed restructuring was exactly that--a reallocation which did not have any impact whatsoever on Edison's overall revenue requirement. The franchise fees were already included in Edison's overall rate structure; the Commission's order simply redistributed them. Because the rider here "merely facilitates direct recovery of a particular cost, without direct impact on the utility's rate of return" (*Citizens Utility Board*, 166 Ill. 2d at 138, 651 N.E.2d at 1102), it was not an abuse of discretion for the Commission to use it as the mechanism of cost recovery.

(*Id*. at 628-629)

In contrast, authorizing rider recovery for a return on additional capital expenditures is a unidirectional rider (ratepayers can only pay more – not less -- than they otherwise would without such a rider) that will directly increase a utility's revenue requirement, and is nothing short of a single-issue rate increase. Unlike rider recovery of operating expenses, the use of a rider for a return on additional capital expenditures is not a **substitute** or **alternative** to base rate treatment of such costs that eliminates or decreases the dangers of single-issue ratemaking.[14] Instead of facilitating direct recovery of a particular cost that would otherwise be recovered in existing base rates, rider recovery for a return on additional capital expenditures facilitates the additional recovery of new costs that would (and should) otherwise be recovered in the utility's next rate case.

Indeed, Staff seriously questions whether the reasoning that supported the finding of authority to approve riders in *City of Chicago v. Illinois Commerce Comm'n*, 13 Ill. 2d 607 (1958) is applicable to riders for the recovery of a return on new capital investments. The court in *City of Chicago* relied upon the broad definition of "rate" to find that the statutory authority to approve rates under the PUA includes the authority to approve a formula based rate for the recovery of a variable expense; and relied upon a Virginia Supreme Court decision to find that a formula based rate to recover a variable expense did not violate the requirement for notice of changes in rates under the PUA because the PUA requires notice of changes in filed schedules rather than notice of changes in ratepayers bill under a formula based rate. (*Id*. at 611-614) While the reasoning of the court supports a finding that the PUA permits formula rates to recover variable expenses, that same reasoning becomes much more tenuous when applied to a rider whose actual purpose is to increase rates to recover new costs.

[14] The Company implicitly acknowledges the distinction between a recovery of operating expenses and a return on new plant investment, having submitted alternative operating expense numbers for commodity-related uncollectibles expense (including them without Rider UBA and excluding them with Rider UBA), but not submitting alternative numbers in connection with Rider ICR.

b. The Company's Benefits Analysis Is Flawed and Deficient

The Company's position is that Rider ICR will enable it to make additional investments in its CI/DI main replacement program without what it calls the negative financial consequences such actions would create under traditional ratemaking methods, and that additional investments in the CI/DI main replacement program will provide certain benefits. (Peoples Gas Ex. JFS-1.0, p. 4; Tr., pp. 1615-1616; NS-PGL IB, pp. 121-125) The Company also refers to these "negative financial consequences" as a "financial detriment." (Tr., pp. 1621, 1643-1644, 1669-1670) The Company has failed to prove up its alleged financial detriment, and its assertions in this regard are not supported by applicable rules and case law. Since the Company has failed to support the major premise underlying its benefits analysis (i.e., that acceleration cannot or should not occur with base rate recovery due to negative financial consequences), the alleged benefits cannot support rider recovery since the record does not establish a legitimate, valid and reasonable link between the alleged benefits and rider (rather than base rate) recovery.

First, the Company has not provided any specific proof regarding the alleged financial detriment, admitting that it has not quantified such financial consequences. (Tr., p. 1621) Second, utilities are afforded the discretion to select an historical or future test year. (83 Ill. Adm. Code § 287.20) If a future test year is selected, the utility may select a consecutive 12 month period based on forecasted data ending up to 24 months after the date new tariffs are filed. (*Id*.) If an historical test year is selected, the utility may reflect changes to plant investment and other items where such changes "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." (83 Ill. Adm. Code § 287.40) Thus, depending on whether an historical or future test year is selected, a utility is permitted to recover the costs of plant investment that will occur within 12 or 24 months of a tariff filing provided that such costs are appropriately supported. Thus, contrary to the Company's claim of negative financial consequences, rules applicable to the establishment of base rates do not prevent it from recovering plant investment that occurs between rate cases.

Staff observes that use of deferred accounting or deferred charges may also provide an additional means for a utility to recover certain costs related to investment in new plant. The standards and rules applicable to recording and recovering deferred charges were discussed at length in *Business & Professional People for the Public Interest v. Illinois Commerce Comm'n*, 146 Ill. 2d 175, 230-249 (1991) ("*BPI II*"). The court explained that recovery of deferred charges involves a two step process or determination. First, a utility must obtain permission for an accounting variance to record the deferred charges. (*Id*. at 232-233) The showings required to qualify for an accounting variance are (i) that circumstances beyond a utility's control created a significant regulatory lag between the in-service date and the date of a rate order, and (ii) that denial of the variance could significantly and adversely affect the company's earnings.[15] (*Id*.) Second, the deferred charges must be properly recoverable in a rate case. (*Id*. at 237-243) As noted in Staff's Initial Brief, the Court in *BPI II* held that the Commission's test year rules prevent recovery of deferred operating expenses

[15] Staff notes that this second standard for an accounting variance – an adverse affect on earnings-- is essentially the same requirement that Staff proposes for alternative Rider ICR through a return credit (i.e., no recovery under Rider ICR if earning in excess of its authorized rate of return).

originating outside of a test year. (Staff IB, pp. 221-224; BPI II, pp. 237-241). However, the court reached a different conclusion with respect to deferred carrying charges because it found that the Commission's test year rules are designed to prevent a mismatching of operating expenses and revenues, and carrying charges on plant investment were found **not** to be operating expenses. (BPI II, pp. 241-243) Thus, deferred accounting also presents another possible means for the Company to recovery a return on its additional investment in CI/DI mains made between rate cases.

The Company's alleged benefits also fail to justify or warrant rider recovery. To justify proposed Rider ICR, Peoples Gas claims that it will allow for "more expeditious replacement and modernization" of the Company's distribution system. (NS-PGL IB, p. 122) This process, the Company claims, will produce savings for ratepayers. (*Id*.) The Company categorizes the benefits it claims will result into: (1) financial benefits associated with spending current dollars for a major monetary undertaking; (2) benefits relating to the replacement of Peoples Gas' low pressure system; and (3) benefits afforded by the opportunity to respond to dynamic development in the City of Chicago. (NS-PGL IB, pp. 123-125).

The Company's claims of benefits from the implementation of the accelerated program under the proposed rider are unsubstantiated. Of all the benefits cited by the Company, the only benefit it has quantified to any extent is leak repair savings of approximately $3,000 per mile of replaced main -- which translates into achievable leak repair savings between $180,000 and $300,000 per year. (Tr., pp. 1549-1552, 1641; NS-PGL IB, p. 123) While the Company admits deferred tax effects could be quantified, it has not done so. (Tr., pp. 1594-1595) The Company provides no estimate of the costs or savings under the accelerated program, nor does it demonstrate that the savings will outweigh the additional costs paid by ratepayers under the proposed rider. (ICC Staff Ex.8.0, pp. 36-37, lines 754-758) For example, Company witness Schott considers it difficult to predict "when and how much money will be spent" under the proposed program. (Peoples Gas Ex. JFS-1.0, p. 13) Nevertheless, he considers the costs "too great" to expose Peoples Gas to the financial risk. However, he is willing to expose ratepayers to that risk through the introduction of Rider ICR. (ICC Staff Ex.8.0, p. 39, lines 804-816)

As explained by Staff witness Lazare, the argument by Peoples Gas that the rider is needed for opportunities that cannot be known in advance and, thus, cannot be budgeted is problematic as well. Peoples Gas has been providing service to customers in Chicago since the 1850s. After 150 years it should be used to dealing with special projects and events sponsored by the City and other parties. Furthermore, since 1981, Peoples Gas has been able to conduct a main replacement program without the need for a rider, demonstrating that it is possible to plan and budget for a main replacement program despite the existence of special projects and events. (ICC Staff Ex.8.0, pp. 37-38, lines 775-785)

More specifically, the Company states that a benefit of accelerated CI/DI main replacement is the ability to coordinate work with the City of Chicago and reduce street repair costs. (Tr., pp. 1619-1620) However, the ability to coordinate CI/DI main replacement with street or other infrastructure work by the City of Chicago exists regardless of whether costs are recovered through base rates or a rider. Indeed, the Company admits that it could accelerate its CI/DI main replacement (and thereby receive the benefits of accelerated replacement it relies upon) using traditional base rate recovery for those costs. (Tr., pp. 1620-1621)

Since the benefits cited by Peoples Gas relate to CI/DI main replacement – such as modernizing and strengthening a significant component of City of Chicago infrastructure, safety and maintenance benefits from replacement of its low pressure distribution system, and responding to dynamic development in the City of Chicago -- those benefits also occur with the CI/DI main replacement that occurs through base rates. (Tr., pp. 1622-1625, 1640-1641) The only real difference offered by Peoples Gas witness Mr. Schott related to the timing or degree of benefits based on the premise that the CI/DI main replacement would only be accelerated with Rider ICR (Tr., pp. 1640-1641), but as indicated above there is nothing preventing the Company from deciding to increase the pace of its CI/DI main replacement program using base rate recovery.

Finally, as discussed earlier, under the *Bell* and *Finkl* decisions the Commission does not possess a general authority to implement incentive-based alternative regulation, nor may it rely on such incentives to justify rider recovery. The Company's position contends that rider recovery is necessary to provide it appropriate financial incentives to accelerate its CI/DI main replacement program, and thus the Company's justification for rider recovery is improper and must be rejected.

Rather than provide justification for rider recovery, the benefits and savings highlighted by the Company merely serve to emphasize that its proposed rider constitutes improper and unfair single-issue ratemaking. Peoples Gas acknowledges that the replacement of cast iron mains with plastic mains will eliminate operation and maintenance problems associated with cast iron maintenance. (Tr., pp. 1548-1549) Peoples Gas further acknowledges that the conversion from CI/DI mains to plastic mains is expected to result in annual O&M leak repair savings ranging from $180,000 to $300,000 per year. (Tr., pp. 1549-1551) However, Rider ICR does not flow such directly related anticipated savings to ratepayers or otherwise take them into account; rather, Peoples Gas would retains all such cost savings under Rider ICR. (Tr., p. 1551) The Company further acknowledges O&M savings associated with elimination of low pressure regulator stations, and those savings are not taken into account in Rider ICR. (Tr., pp. 1553-1554) Similarly, inside meter inspections are eliminated by the replacement of CI/DI mains since meters are moved from inside locations to outside locations in connection with converting from a low pressure CI/DI main system to a medium pressure main system, but such cost savings are not reflected in Rider ICR. (Tr., pp. 1554-1555)

While the Companies never offer a standard or even factors that apply with respect to justification of rider recovery, their benefits argument is premised on the view that a rider is allowable on a simple cost-benefits analysis. While they have not even made that showing, the analysis submitted by Staff in its Initial Brief and this Repy Brief demonstrates that much more is required.

3. Rider ICR Mechanism

The Company states in its Initial Brief that:

> Only Rider ICR adequately addresses the financial impact of the magnitude and uncertainty that accelerating CI/DI main replacement would entail on an ongoing basis. Only Rider ICR would allow Peoples Gas the financial wherewithal to respond to external forces and events and thereby manage the unpredictability and uniqueness of the opportunities which acceleration would afford.

(NS-PGL IB, p. 125) To the extent that this statement is meant to imply that Rider ICR satisfies applicable legal requirements for rider recovery, it is completely off base and incorrect.

As noted above, the Company has done nothing to demonstrate the magnitude of its alleged financial detriment regarding rate base versus rider recovery of capital costs, and its view on base rate recovery of capital costs is contrary to applicable rules and case law. With respect to the CI/DI main replacement program itself, the Company has not demonstrated any variability in costs. Indeed, the only capital expense cost factor the Company identifies is street repair costs (assuming those costs are capitalized), and there is nothing to indicate the magnitude of those costs or the amount of alleged savings from better opportunities to coordinate. The Company has submitted no testimony indicating any variability in any other cost of replacing CI/DI main. Similarly, the reference to unpredictability is nothing short of a gross exaggeration. The only unpredictability asserted by the Company is not knowing on a long term basis what street or other infrastructure projects the City of Chicago may be undertaking. Other than street or sidewalk repair costs, the Company has not shown how this limited "unpredictability" impacts CI/DI main replacement. Similarly, the Company's statement that Rider ICR "resolves difficulties and uncertainties surrounding projecting the precise level of infrastructure costs that might be expended" is simply a dressed up statement regarding street and sidewalk repair costs. (NS-PGL IB, pp. 125-126)

4. Rider ICR Modifications

Although Peoples Gas has accepted certain modifications to its original Rider ICR proposal based on certain changes recommended by Staff (in the alternative), it also appears to maintain that its original Rider ICR proposal is on the table. (NS-PGL IB, pp. 121, 126; Tr., pp. 1542-1543) While it does not appear that the original Rider ICR proposal is seriously advocated at this point since the Company did not address it on the merits in its Initial Brief, the failure of the Company to withdraw it requires Staff to briefly address it.

The Company's original Rider ICR proposal would recover the annual incremental plant investment above the historical 2004-2006 average annual plant investment for Gas Plant Accounts 376.1 (Distribution Mains), 376.3 (Vaults and Regulators), 380.0 (Services), 381.0 (Meter Purchases), 382.0 (Meter Installations), and 383 (House Regulators). (Tr., pp. 1556-1557; GCI Ex. MLB 1.8, pp. 6-7) The alternative Rider ICR proposal does not include such a baseline to identify incremental increases; however, the alternative proposal is limited to CI/DI main replacement costs whereas the original proposal includes all costs in those accounts. (Tr., pp. 1557-1558, 1618-1619) Alternative Rider ICR includes an annual recovery cap based on 5% of total base rate revenue – which would be 5% of approximately $371 million, or roughly $18.5 million on an annual basis. (Tr., pp. 1563-1566) Rider ICR recovers the pre-tax carrying costs and depreciation on the qualified expenditures; thus, assuming annual carrying costs of 12% and annual depreciation expense of 3%, the 5% base rate revenue cap on recovery under alternative Rider ICR would limit annual recovery of carrying costs and depreciation to roughly $123 million of cumulative capital expenditures. (Tr., pp. 1567-1571).

The Company describes the modifications to its original Rider ICR that it has accepted, including (1) the limitation of recovery to limited to CI/DI main replacement costs, the creation of a separate revenue sub-account, (3) the cap of 5% of base rate revenues, and (4) an annual reconciliation of prudently incurred costs. (NS-PGL IB, p. 126) The Company did not accept certain proposed modifications as discussed below. Staff wants to be clear that all of these modifications are beneficial and reasonable, and that some of these modifications are critical if the Commission determines to allow rider recovery of additional capital investments. For instance, the prudence review is not just a convenient feature, it is also necessary as the Commission must find that a rider will produce just and reasonable rates and there is no way to determine today whether the costs incurred in the future are just and reasonable as well as used and useful absent a prudence review proceeding. Indeed, Staff notes that the prudence of the Company's proposed acceleration of CI/DI mains is an issue that will need to be determined in such proceedings given the Company's failure to provide empirical analysis in this docket, choosing instead to provide conceptual support only with no hard numbers.

a. Peoples Gas has not established a need-based justification for special rider treatment of additional capital costs under Rider ICR

As discussed above, the Company has submitted a conceptual benefits analysis related to acceleration of its CI/DI main replacement program, but has not asserted or demonstrated that there is a compelling need for such acceleration. The Company essentially acknowledges that it has not demonstrated a compelling need the acceleration, but responds that Rider ICR that was proposed to reduce the costs of main replacements, to allow the Company to respond to "unknown, unforeseen and unpredictable opportunities", and to facilitate other benefits. (NS-PGL IB, p. 127) The Company asserts that just because "Peoples Gas has replaced main safely and efficiently since 1981 does not diminish the propriety of enhancing that activity and achieving greater savings than might otherwise result." (*Id*.)

The Company's statements simply restate its benefits and other arguments that have been addressed elsewhere in this Reply Brief, and Staff will not repeat those arguments here. What Staff will state is that the Company's comments highlight the fact that the instant case simply does not present the question of whether a rider would be justified if significant safety issues required an acceleration of its CI/DI main replacement program. That issue is simply not presented for consideration in the instant docket.

b. The Company's criticism's of Staff's concerns regarding rider recovery are totally lacking in merit

The Company asserts that Staff and Intervenors have opposed Rider ICR on "rigid prescriptions" that is does not agree exist. As amply demonstrated elsewhere in this Reply Brief and Staff's Initial Brief, there are requirements and legal principles applicable to a request for rider recovery – and Peoples Gas has chosen to ignore them. As demonstrated elsewhere, the Company's request for rider recovery of additional capital expenditure is inappropriate.

c. Rider ICR would require ratepayers to pay a premium for ordinary utility service

The Company also seeks to rebut criticism of proposed Rider ICR. The Company denies Staff's contention that the rider would require ratepayers to pay a premium for ordinary utility service. Peoples Gas argues that "[a]side from time value of money considerations, Rider ICR would not result in additional costs to ratepayers over what would be paid in any event for CI/DI main replacement in the aggregate and Peoples

Gas will not obtain any financial benefit that is different from the rate case treatment which it is normally accorded for capital expenditures." (NS-PGL IB, p. 128) This statement cannot obscure the undisputed fact that the proposed Rider would allow the Company to pass along additional rate base costs to customers without having to file a new rate case. The ability to pass along these additional costs under Rider ICR represents an extraordinary cost to ratepayers who, in turn, would receive no additional benefit beyond normal utility service. The recovery of additional rate base investments between rate cases is an extraordinary expense for ratepayers despite the Company's claim to the contrary.

d. A rate of return credit is required

Staff has fully addressed the Company's argument regarding the return credit provision (NS-PGL IB, p. 129-130) in its Initial Brief (Staff IB, pp. 196-202), and Staff will not repeat those arguments here. What Staff will point out, however, is the complete inconsistency in the Company's statements in its Initial Brief. The Company asserts that under Rider ICR "Peoples Gas will not obtain any financial benefit that is different from the rate case treatment which it is normally accorded for capital expenditures." (NS-PGL IB, p. 128) As explained in Staff's Initial Brief, rates are designed to permit a utility to recover its revenue requirement, which includes its authorized rate of return. Thus, a utility is not allowed in a rate case to establish rates that would recover more than its authorized rate of return. The return credit provision is a protection for rate payers that would prevent the establishment of rates under Rider ICR that would allow it to recover more than its authorized rate of return. Contrary to its representation that Rider ICR does not permit it to obtain a financial benefit that is different from the rate case treatment normally accorded for capital expenditures, Peoples Gas opposes the return credit provision which attempts to limit the Company to the treatment it would obtain in a rate case.

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

1. Merits of Proposed Energy Efficiency Program

Staff thoroughly discussed, in its Initial Brief, that the entity that operates the EEP should be accountable and efficient. (*See* ICC Staff IB, pp. 206-207)

As City-CUB and the AG note, Staff is the only party that opposed the EEP, (City-CUB IB, pp. 85-86; AG IB, p. 100) although most parties oppose a rider to fund the program. Staff, however, bases its opposition, at least in part, on the program's inequities: all customers pay, but not all benefit. CUB-CITY and ELPC argue that Staff uses a higher standard for EEP than for other costs. (City-CUB IB, pp. 85-86; ELPC IB, p. 10) Staff disagrees. During cross examination, Dr. Rearden was offered several examples of programs (as one example, uncollectibles (ELPC IB, p. 10)) that allegedly did not benefit all ratepayers. While Dr. Rearden may have agreed that not all ratepayers do directly benefit from all program,, Dr. Rearden did offer his opinion that ratepayers received system benefits that are indirect in reference to the examples presented to him. (Transcript 9-11-07 pp. 730-731) Nevertheless, Dr. Rearden strongly disagreed that efficiency investment provides other system benefits that may indirectly benefit ratepayers. (Id., pp. 740-743; ICC Staff Ex. 24.0, pp.36-37)

The second source for disagreement between Staff and intervenors concerned the intervenors' notions that EEP enhances efficiency because it corrects for market imperfections. (City-CUB IB, pp. 86-87; ELPC IB, pp. 9-10) Staff admits that inefficiencies can impede investment in any market, but it argues that the support for the level of inefficiency and what investment would be absent the EEP is absent from the record, and thus, the intervenor's argument has not been supported. (Transcript, pp. 735-737; ICC Staff IB, p. 204) ELPC disagrees, in its Initial Brief, it states that "…the Commission should give greater weight to the testimony and exhibits submitted by ELPC because it provided in-depth evidence as to current investment levels in energy efficiency and the specific cost savings that can be provided by energy efficiency measures." (ELPC IB, pp. 9-10) First, Staff notes that this statement is not supported by a citation to the record. It is unknown where ELPC introduced this information into the record. Staff maintains that no party demonstrated that the current level of investment was inefficient. Indeed, ELPC and others couldn't even show what the current level of investment is, or how much it 'should' be increased to, to improve welfare (AG IB, pp. 101-102).[16]

Second, Staff never argued that market imperfections do not exist, only that that their magnitude was significant enough to justify the program. In his cross, Dr. Rearden repeatedly stated this point. (Tr., pp. 732-737)

Staff notes that City-CUB agree with Staff that there should be limits on overheads in order to make the program as effective as possible. (City-CUB IB, pp. 87-89)

[16] ELPC did introduce information about average gas consumption per household. It concludes from this information that there is 'underinvestment.' (ELPC IB, pp. 8-9) ELPC never explains what the right level of investment is. Staff disagrees that per capita consumption comparisons between states can prove that energy efficiency investment is below optimal levels. For example, the Commission is given no information about the cost to achieve those efficiencies. (ICC Staff IB, p.204) The AG also mistakenly attempts to infer from this information what the 'investment level' is. (AG IB, pp. 101-102)

Finally, Staff feels compelled to repeat its position regarding alleged system benefits. In particular, both ELPC and City-CUB claim that there is an economic development effect from the EEP, since gas is primarily purchased out-of-state and energy efficiency vendors are in-state entities. (ELPC IB, pp. 5-6; City-CUB IB, p. 88; AG IB, pp. 102-103) ELPC also claims that energy efficiency investment can lower gas prices by reducing demand. (ELPC IB, pp. 6-7) Both claims are specious. While there may be nominal and unobservable effects on gas prices, it is not obvious that there are any economic development effects at all. (ICC Staff IB, pp. 207-208)

2. Proposal for Rider Recovery of EEP Costs

The Companies present two arguments for the proposed Rider EEP. One is that precedent exists for rider treatment of these costs. (NS-PGL IB, p. 133) Peoples Gas and North Shore argue that since these expenditures were recovered through a rider in the past, they must be the kind of costs that deserve rider treatment. (NS-PGL IB, p. 135) Second, the Companies argue that potential exists for customers to fund energy efficiency costs under a statewide program and the Companies would not want to burden ratepayers with the cost of multiple programs. (NS-PGL IB, p. 133)

These arguments fall short in a number of respects. First, the prior rider allowing recovery of the incremental cost of energy efficiency and conservation measures occurred in the context of conducting pilot energy conservation programs to test the effectiveness of various types of conservation programs by all utilities. (*In re An Investigation Concerning the Propriety and Appropriateness of the Development and Implementation of Energy Conservation Programs by The Peoples Gas Light and Coke Company*, Docket No. 83-0034, 1993 Ill. PUC LEXIS 48, p. 2 (Order Feb. 10, 1993); *In* *re An Investigation Concerning the Propriety and Appropriateness of the Development and Implementation of Energy Conservation Programs by The Peoples Gas Light and Coke Company*, Docket No. 83-0034, 1989 Ill. PUC LEXIS 417, p. 3 (Eighth Supp. Int. Order Nov. 8, 1989)) This is hardly the situation in the instant case. Further, the Companies cite to no order by the Commission explaining the basis on which rider recovery was approved, so the fact of prior approval is of little assistance in evaluating the current proposal. Moreover, while the Commission did generally find that the costs of energy efficiency and conservation measures were recoverable through riders in the 1990s, that practice was rejected by the courts, as previously discussed, in *A. Finkl & Sons Co. v. Illinois Commerce Comm'n*, 250 Ill. App. 3d 317 (1st Dist. 1993).

Second, the fact that the rider was used in the past is insufficient reason for its adoption in the current proceeding. The previous existence of a rider for energy efficiency and conservation expenditures does not constitute proof that the specific expenditures contemplated in this docket must be subject to rider treatment. The Commission's decision whether to approve Rider EEP should focus on whether the proposed rider is warranted under applicable legal standards and meets the current needs of the Companies and their ratepayers. The evidence clearly demonstrates it does not.

The second argument is even less compelling. The Companies' reference to the "possibility" of a statewide program fails to address the likelihood that such a program will be implemented and the content and costs of the program to be adopted. This considerable uncertainty would warrant against adopting the cumbersome Rider EEP in the current proceeding.

The Companies further argue that the refund procedures under the proposed rider would protect ratepayers from overpaying if these costs were to decline over time. (NS-PGL IB, p. 136) However, the fact that refunds could reach 75% of projected annual expenditures only attests to a lack of effective planning for the program.

The Companies also note that similar riders have been adopted in other states and imply that this provides momentum for their adoption in Illinois. (NS-PGL IB, p. 136) What other states do has no bearing on whether rider recovery is appropriate under Illinois law, and Staff believes it would be dangerous practice to reflexively follow the path taken by others without receiving a satisfactory answer to the question why Rider EEP should be considered appropriate for Peoples Gas and North Shore customers. A reasonable answer has not been provided in this docket, and for that reason the proposed Rider EEP should be rejected.

The Companies respond to claims by AG witness Brosch that the size of the EEP recoveries does not justify the adoption of a rider for these costs. (NS-PGL IB, p. 135) Peoples Gas and North Shore argue that the size of the expenditures to be recovered under a rider should have no bearing on whether the rider should be employed if the costs otherwise are suitable for rider treatment. (NS-PGL IB, p. 135) First, the Companies' argument is simply unreasonable. There is a cost associated with implementing and administering riders. As recent experience with the Companies' gas cost riders shows, this cost can become significant. If the revenues to be recovered under the rider are small, then the costs could outweigh any possible benefits. Thus, the amount of revenues to be recovered is an important consideration in deciding whether to approve the rider. The fact that Peoples Gas and North Shore would deny this basic truth calls their judgment into question. Furthermore, if they fail to understand this adverse consequence associated with riders, then the question arises whether they have adequately balanced benefits and costs, not only for Rider EEP but for all of the riders they propose in this docket.

Second, the Company's assertion that the size of the expenditures to be recovered under a rider should have no bearing on whether the rider should be employed is contrary to the longstanding view of the Commission. In considering whether to approve rider recovery of operating expenses, the Commission has long held that the size of the cost involved one of the factors that weigh in favor of justifying rider recovery:

> A fuel adjustment clause ("FAC") is a tariff provision, approved by the Commission in advance, as a policy option, whereby a change in certain fuel costs and incidental costs thereto will automatically permit a change in the price charged consumers, without the delay and expense of a formal regulatory hearing. This mechanism eases administrative burdens and reduces the likelihood of financial jeopardy of the utility during adverse economic conditions. The clause is simply the addition of a mathematical formula to the filed schedules of the utility. The clause is not a substitute for a formal rate case but is only an interim measure to function between rate cases, adjusting for cost changes which continually occur in the marketplace. **The categories of costs to be passed through the FAC are those that are for the most part beyond the control of the utility, significant, and capable of being measured with certainty.** At this time, it is appropriate that proper costs passed through must be actual, not projected or estimated costs.
>
> **Fuel costs represent a substantial portion of operating costs; in some instances, fuel costs alone comprise more than half of a utility's total operating costs.** Any fluctuation in fuel costs has a significant impact on a utility's earnings unless some means exists to recoup those increased costs as quickly as possible. These fuel costs are a highly volatile expense item; more so than other expenses such as wages or maintenance. **When the volatility factor is coupled with the magnitude of the fuel costs, one can readily conclude that the fuel adjustment clause is both a necessary and a proper regulatory tool to insure that both the customer and the utility receive the benefits of early recognition of changes in the cost of generating electricity.**

(*In re Adoption of Uniform Fuel Adjustment Clause(s)*, Docket No. 78-0457, 1981 Ill. PUC LEXIS 7, pp. 5-7 (Order, Nov. 10, 1981) (emphasis added))

E. Rider UBA

Rider UBA seeks rider recovery of an operating expense (commodity-related uncollectibles expense). Thus, the main issue with respect to this proposal is whether the Companies have established that special rider recovery of this operating expense is warranted. In order for an operating expense to warrant special rider treatment, it must generally be shown that the expense is substantial and sufficiently volatile, fluctuating, and unpredictable so as to warrant different treatment than other operating expenses. (*Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111, 138-139 (1995)) In their Initial Brief, the Companies do not support the need for cost recovery of uncollectibles expense outside of base rates. Instead, the Companies have presented evidence that only contradicts their claims that uncollectibles' costs are volatile, fluctuating, and unpredictable, and then claim, as a matter of public policy, that it would be "unreasonable, unjust and unsound" to continue to collect uncollectibles through traditional ratemaking. (NS-PGL IB p. 140)

Essentially, the Companies claim that uncollectibles' costs are rising and are largely out of their control, and the static approach of the past fails to address the volatile nature of these costs. (NS-PGL IB p. 137) The Companies also claim that the financial community recognizes the negative financial impact of bad debt and, thus, the need for regulatory relief. (*Id.*) Nevertheless, the evidence in the instant proceeding does not support the Companies' claim that rider recovery of uncollectibles expenses is warranted.

In fact, the Commission has already assessed and declined a similar attempt by Northern Illinois Gas Company ("Nicor") to recover uncollectibles' expenses through a rider, and concluded, "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." (*Re Nicor*, Illinois Commerce Commission, Docket No. 04-0779, Sept. 20, 2005, p. 181, "Nicor Order") The Commission's standard is the fundamental groundwork laid down by the courts in establishing the threshold for rider recovery of costs. (Staff IB, pp. 124-152; *See also Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111, 137-138 (1995)) First, it is incumbent upon the utility to demonstrate that rider recovery is warranted. (220 ILCS 5/9-201(c)) Second, the costs to be recovered by the rider must be unique, volatile, fluctuating, and unpredictable. (*Citizens Util. Bd. v. Illinois Commerce Comm'n*, 166 Ill. 2d 111 (1995)

The Companies in the instant proceeding do not demonstrate that their uncollectibles' expenses are unique, volatile, fluctuating, or unpredictable. This is not a case of first impression. The Nicor Order found uncollectibles to not be a unique cost. (Nicor Order at 181) Peoples Gas and North Shore Gas have not presented any evidence to controvert a sound finding established just two years ago, and therefore the Commission should maintain the ruling in the Nicor Order.

Second, the Companies have not established uncollectibles' costs as volatile, fluctuating or unpredictable; in contrast, the Companies have presented evidence demonstrating uncollectibles' costs are reasonably stable. For one, they fail to establish that the magnitude and volatility of bad debt expenses in recent years have reached unmanageable levels. Supporting data provided by Companies witness Borgard, and discussed by witness Feingold, demonstrates that Peoples Gas' total bad debt levels doubled from just under $20 million in 2000 to almost $40 million in 2001. (Peoples Gas Ex. LTB-1.5) However, as noted in Staff's Initial Brief, the exhibit also reveals that total bad debt was relatively stable in other years. (Staff IB, pp. 215-214) From 1996 to 2000, it steadily declined from just over $25 million to just under $20 million. Between 2001 and 2003, the level was approximately $40 million each year. In 2004 and 2005, it dropped to $35 million each year. The relative stability for most of this decade suggests that uncollectible expenses are not quite as volatile and unpredictable as the Companies claim. (ICC Staff Ex.8.0, pp. 23-24, lines 522-535)

The corresponding exhibit for North Shore (North Shore Gas Ex. LTB-1.4) also undermines the Companies' arguments. It indicates that bad debt hovered between approximately $600,000 and $800,000 from 1996 to 2000. It then increased to almost $1.4 million in 2001 and ranged between approximately $1.2 million and $1.6 million between 2001 and 2005. These figures also fail to indicate that North Shore's bad debt is as volatile as the Company suggests. (ICC Staff Ex.8.0, p. 24, lines 537-542)

Moreover, several statements in the Companies' Initial Brief provide evidence of predictability and subsequent solutions to bad debt expenses. First, the Companies obviously see the problem: "[h]igher customer bills result in more customers being slow or unable to pay, with higher delinquencies as the consequence." (NS-PGL IB p. 137) Second, the Companies see the cause: "one of the major business challenges facing the Utilities is rising uncontrollable bad debt expenses *caused primarily by the level of* *wholesale natural gas prices*." (*Id. emphasis added)* Third, the Companies see the solution: "regulatory relief" in response to fluctuating gas price levels. (*Id.* at 137-138)

Staff discussed the correlating spike in uncollectibles' costs and the spike in natural gas prices in 2001, in its Initial Brief and concluded that the increase in uncollectibles stemmed from this one spike. Furthermore, Staff noted that when prices later stabilized at a higher average, uncollectible costs also stabilized at a higher average. (*See* Staff IB, pp. 216-217) Thus, the knowledge that a commodity price spike will increase consumers inability to pay, which in turn increases a utilities cost of uncollectibles is evidence that uncollectibles costs are not volatile, unpredictable, or fluctuating, but merely another aspect of the Companies' business that can be planned for and addressed within the traditional regulatory paradigm.

Thus, Staff contends that there is no evidence that traditional ratemaking cannot assist in collecting uncollectibles' expenses. The Companies have demonstrated that uncollectibles' costs where manageable in the first four years following a rate increase. Once gas prices spiked, causing a definable jump in customer bills and subsequently customer delinquencies, actual uncollectibles costs exceeded the base rate allowances set in 1996 for Peoples and North Shore. Thus, at that time, the Companies had at their disposal all the regulatory relief necessary—application for a general rate increase that would increase the base rate allowance for uncollectibles' expenses. The Companies did not avail themselves of this relief, and in the instant proceeding, have demonstrated no reason to be granted such extraordinary and unreviewable recovery for costs that have proven to be stable with the cost of gas.

Furthermore, the Companies fail to propose any arguments to refute Staff witness Lazare's testimony demonstrating that bad debt expenses are not volatile and unpredictable, especially when compared to other operating expenses. (See Staff Ex. 8.0) Staff compared uncollectible expenses with other operating expenses for Peoples Gas and North Shore. The comparison supports two conclusions. First, that the Companies' uncollectible expenses are not significant relative to other operating expenses (less purchased gas costs); and, second, the Companies' uncollectible expense fluctuates much less than those expenses. (ICC Staff Ex.8.0, pp.25-26, lines 556-565) Lacking the evidentiary record to support their position, the Companies attempt to dismiss this evidence by asserting, with no citation or other support, that "[t]he relationship between bad debt and operating expenses is irrelevant as to whether bad debt expenses are significant." (NS-PGL IB, p. 139) The Companies' argument that a comparison of uncollectibles expense and other operating expenses is irrelevant is dead wrong and contrary to law.

In *Finkl* the court held that DSM related expenses to be ordinary expense not entitled to special rider treatment, and in so holding relied explicitly on the fact that the expenses for which rider recovery was sought "reveal no greater potential for unexpected, volatile or fluctuating expenses which Edison cannot control, than costs incurred in estimating base ratemaking." (*Finkl*, 250 Ill. App3d 317, 326-327) Applied to the instant case, the *Finkl* opinion demonstrates that Staff's comparison of rider expenses to operating expenses is indeed relevant; and rider recovery is not justified since such comparison reveals that uncollectibles expense has no greater potential for unexpected, volatile or fluctuating expenses than the Companies' other operating expenses.

Moreover, in contrast to uncollectibles' expense, ICC Staff Ex. 8.0 found that the Companies' purchased gas costs (as recovered through Rider 2) are, in fact, volatile and do fluctuate compared with total operating expenses—while any link between purchased gas costs and uncollectibles only shows that extreme spikes cause fluctuation that quickly settles back down. Thus, unlike the Companies' uncollectible expense, purchased gas costs fluctuate significantly and do warrant special rider treatment under the longstanding Purchased Gas Adjustment Rider. (ICC Staff Ex.8.0, pp. 28-29, lines 576-584)

In approving the Uniform Fuel Adjustment Clause, the Commission ruled that "it is appropriate that proper costs passed through must be actual, not projected or estimated costs." (*See* UFAC Order, pp. 5-7) Rider UBA, as described by the Companies witness Grace, will be based on forecasted gas costs, and will therefore not be an "actual" cost passed through the Companies Proposed Rider UBA. (Peoples Gas Ex. VG-1.0, p.44)

In addition, the Companies off-handedly dismissed, in footnotes, but failed to address in their Initial Brief, Staff's claim that uncollectibles' costs do not warrant rider recovery because even as uncollectibles expense climbed, Peoples Gas and North Shore were able to earn their Commission-authorized rates of return. (NS-PGL IB p. 139, footnote 25) In 2001 when bad debt costs increased significantly, Peoples Gas (North Shore) earned a return on common equity of 11.14% and 12.30%. When North Shore's uncollectibles expense rose by $660,000 in 2002, it still earned a return on equity of 12.72%. Thus, if Rider UBA had been in effect during this time, both utilities would have received additional revenue boosts despite earning at or above their authorized returns. (ICC Staff Ex. 20.0, pp. 6-7, lines 131-140)

The Companies seek to demonstrate support for their proposal by arguing that acceptance in 10 out of 51 regulatory commissions of uncollectibles' expense riders demonstrates they "have been widely accepted across the country." (NS-PGL Initial Brief p. 140) The Companies have again failed their burden of proof to demonstrate that such a rider is just and reasonable for Illinois ratepayers. The record does not reflect what the conditions are like in those 10 states, nor does it reflect how similar those riders are to the Companies proposed rider. The Companies expect the Commission to therefore, blindly trust that this 20% approval level provides compelling evidence for approval in this docket without supporting their claim with any convincing evidence.

Thus, Staff cannot recommend adoption of Rider UBA, as the Companies have failed to meet their burden of proof to demonstrate that the Rider will create just and reasonable rates, that the costs to be specially recovered by this rider are volatile, fluctuating, and unpredictable, and that special recovery is favored by sound public policy decision making.

F. Deferred Accounting Alternative to Rider Requests

Although the Companies indicated in testimony that deferred accounting should be applied if their Rider VBA, Rider UBA and Rider EEP proposals were rejected (*see* Staff IB, p. 221), they do not address these proposals in their Initial Brief except to note a deferred accounting procedure for Rider EEP. (NS-PGL IB, p. 135) As explained in

Staff's Initial Brief and earlier in this brief, deferred recovery is not allowable for operating expenses under the Commission's test year rules and the supreme court's decision in *BPI II*. (Staff IB, pp. 221-226) Thus, this alternative is not viable under Illinois law. Staff also notes that the Company states that the deferred treatment it prefers is one that would work on an annual basis instead of between rate cases. (NS-PGL IB, p. 135) This statement amounts to nothing more than a proposal for an alternative rider, which would not be appropriate or allowable for all the reasons indicated above.

VIII. COST OF SERVICE

B. Embedded Cost of Service Study

2. Contested Issues

a. Coincident Peak Versus Average and Peak Allocation Methods

North Shore and Peoples Gas proposed the use of Coincident Peak ("CP") in the allocation of distribution costs, rather than endorsing the more reasonable Average and Peak ("A & P") (NS-PGL IB, pp. 143-144) recommended by Staff (Staff IB, pp. 227-230) as well as the Citizens Utilities Board and the City of Chicago. The Companies repeat the same argument, consistently rejected by the Commission, that the system was built to meet peak demand, and if it had been built to accommodate only average demand, the system would not be able to meet peak demands. The problem, as explained in Staff's Initial Brief, is that the peak design parameters of the distribution system are only a part of the cost story because increases in capacity to meet peak demand account for only a portion of the costs to build the distribution system. Other costs are not influenced by capacity, as demonstrated in a cost equation provided by North Shore and Peoples Gas witness Amen. Since capacity increases account for only a portion of the costs of the distribution system, it is reasonable to allocate costs not only according to use on the design day peak, but also according to how the system is used throughout the year. A&P addresses both the costs incurred to increase capacity, which is the “P” factor of an A&P allocation, and the costs to have a system in place for use throughout the year, which is the “A” factor of an A&P allocation. In addition to the foregoing, Staff notes that the Commission’s adoption of an A&P allocation methodology has been upheld on appeal. (*See Abbott Lab. v. Illinois Commerce Comm'n*, 289 Ill. App. 3d 705, 716-717 (1st Dist. 1997) (Commission’s adoption of A&P is supported by substantial evidence.)

In concluding that A&P is a more appropriate method of allocating distribution system costs than CP, previous Commission Orders have discussed factors other than capacity, such as safety, reliability, and equipment replacement as being significant elements in the cost of the distribution system. In fact, the Orders in the previous North Shore and Peoples Gas rate proceedings recognized those concerns in the development of the distribution system as factors that are not peak-related, and found that transmission and distribution costs should be allocated according to Staff’s A&P allocation factor. (Order, Docket No. 95-0031, pp. 36-37, and Order, Docket No. 95-0032, pp. 42-43) Thus, the Commission should once again reject the Companies’ proposed CP allocation factor because it fails to address costs that are not peak-related, and accept Staff’s A&P allocation factor which recognizes and reasonably allocates transmission and distribution costs that are not only peak-related, but also affected by concerns other than design day peak.

b. Classification of Uncollectible Account Expenses Account No. 904

North Shore and Peoples Gas continue their claim that uncollectible accounts expense is not affected by the different charges on a customer's bill, such as the fixed customer charge and the variable usage charge. (NS-PGL IB, pp. 144-145) The Companies' cost of service study witness recognized that costs that are not recovered from uncollectible accounts are a blend of customer costs billed through the customer charge, and unrecovered demand and distribution costs billed through variable usage and demand charges. (Tr. pp. 343, 346-347) If a customer with a customer charge of $19.00 and usage charges of $15.00 does not pay his bill, a total of $34.00 becomes uncollectible. If another customer with the same $19.00 customer charge but $400.00 in usage charges does not pay her bill, $419.00 becomes uncollectible. (Tr. pp. 346-347) The customer who does not pay her $419.00 bill adds a far greater amount to uncollectible expense because her bill included $400.00 in usage charges compared to the $34.00 uncollectible account that had only $15.00 in usage charges.

Clearly then, uncollectible accounts expense are affected by the charges on a customer's bill that become uncollectible. Since a portion of a customer's account that becomes uncollectible is comprised of a fixed customer charge, it is reasonable to recover a portion of uncollectible accounts expense through the customer charge. Since another portion of a customer's account that becomes uncollectible is comprised of variable usage and possibly demand charges, it is similarly reasonable, and appropriate, to recover a portion of uncollectible accounts expense through variable usage and demand charges. Nonetheless, for reasons that do not make sense, the Companies claim that uncollectible expenses have no bearing on whether the expenses are fixed or variable charges or the specific costs which may be covered by those bills. (NS-PGL IB, p. 145)

The Companies are wrong in claiming that Staff witness Luth seeks to use rate design as justification for cost classification and allocation in an ECOSS, because Mr. Luth is not seeking to change the results of the ECOSS to change how rates are designed. The expense of uncollectible accounts is a function of, and affected by, the underlying charges on a customer's bill that is unpaid. Uncollectible accounts should not be considered solely a customer cost because customer costs are not the only costs that are not paid on an uncollectible account. Therefore, uncollectible accounts expense should be allocated according to the origin of the charges because the costs included in all charges on an uncollectible account are not recovered as a result of bills that are not paid. The Commission should therefore conclude that the amount of uncollectible accounts expense is caused by the charges that appear on the bills that become unpaid and uncollectible, making it appropriate to allocate uncollectible accounts expense according to the blend of costs that result in the charges on bills of uncollectible customer accounts.

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

The Companies apparently cannot administer Staff witness Luth's recommendations that North Shore and Peoples Gas SC 1N and SC 1H customers have the opportunity to be billed for a minimum of 12 months under SC 1N and SC 1H, depending upon how the customer believes that gas service will be used over the next heating season. (NS-PGL IB, p. 149 and ICC Staff Exhibit 19.0, pp. 9-11, lines 178-211) If the Companies cannot administer and advise SC 1N and SC 1H customers of a potential choice between billing under SC 1N or SC 1H, then the Companies should abandon their proposal to separate residential customers into non-heating uses (SC 1N) and heating uses (SC 1H). (ICC Staff Exhibit 19.0, pp. 11, line 215-227) Cost of service for SC 1N and SC 1H should be combined, with rates based upon the combined cost of service with the lower customer charge with Rider UBA that is between the proposed SC 1N and SC 1H customer charges, as shown in the surrebuttal testimony of North Shore and Peoples Gas witness Grace (Staff IB, p. 236; referencing Customer Charge with Rider UBA in Exhibit VG 3.1, columns [B] and [D], line 9) Staff does not recommend that the Commission authorize Rider UBA, but it does not make sense that a customer charge is lower with Rider UBA because the proposed Rider UBA would be a variable charge based upon therms delivered. (Staff IB, p. 236)

Staff's recommendations attempt to address significant bill impacts on what probably would be a small number of SC 1N customers. Nonetheless, relatively high-use SC 1N customers should not pay more for the same therms as a SC 1H customer simply because the SC 1N customer does not use natural gas for space heat. Even if 97 percent of potential Peoples Gas SC 1N bills and 91 percent of potential North Shore SC 1N bills would be for 50 therms or less, 3 percent and 9 percent of those respective Peoples Gas and North Shore SC 1N bills would be for more than 50 therms. With rate differentials on deliveries over 50 therms of 38.679¢ per therm at Peoples Gas and 27.406¢ per therm at North Shore under SC 1N and SC 1H rates proposed by the Companies (rate tables in Staff IB, pp. 237-239), therms delivered under SC 1N become far more expensive than therms delivered under SC 1H in short order. For 3 percent of potential Peoples Gas SC 1N customers and 9 percent of potential North Shore SC 1N customers, the billing consequences could be significant. Staff's recommendation that the basis for differentiation of SC 1N and SC 1H customers should be usage, with choice available to customers, is reasonable to prevent unfair bill impacts. Since the Company apparently cannot administer providing notice of choice, and guidance for that choice, to SC 1N and SC 1H customers, SC 1N and SC 1H cost of service should be combined. Rates for a single SC 1 residential customer class should be based upon a $15.79 customer charge at Peoples Gas and $14.69 customer charge at North Shore, with usage charges recovering the balance of the combined SC 1 costs from customers at each respective company at the percentage of revenues and cost of service recommended by Staff.[17]

IX. RATE DESIGN

B. General Rate Design

2. Gas Cost Related Uncollectible Expense

Staff recommends that the Commission reject the Companies' proposed Rider UBA for the recovery of uncollectible gas costs. Instead, the Commission should continue the current practice of including uncollectible gas costs in base distribution rates under review in this docket. The Companies do not agree with Staff witness Luth's determination of the amount that should be included in the rates of customer

[17] At North Shore, the percentage of revenues from SC 1N and SC 1H customers is approximately 76.9797 percent of total revenues from tariffs [($498,735 + $51,319,293 Staff cost of service) divided by $67,313,886 Company-proposed total cost of service]. At Peoples Gas, the percentage of revenues from SC 1N and SC 1H customers is approximately 67.34561 percent of total revenues from tariffs [($26,583,631 + $282,923,565 + $282,787 + $6,856,080 Staff-proposed revenues) divided by $470,180,701 Company-proposed total cost of service.

classes SC 1N, SC 1H, and SC 2. (NS-PGL IB, pp. 160-162) The Companies' objection to Staff's calculation of uncollectible gas costs included in distribution rates is confusing. The Companies recommend recovery of uncollectible gas costs on a per-customer basis if Rider VBA or Rider WNA are approved but Rider UBA is rejected. On the other hand, the Companies indicate that recovery of uncollectible gas costs should be recovered through the distribution charge if Rider UBA is rejected. (NS-PGL IB, p. 162)

Staff did not have an opportunity to respond to the Companies' surrebuttal proposal to possibly bill uncollectible gas costs through the customer charge. Staff strongly believes that under no circumstances should uncollectible gas costs be recovered through the customer charge. Gas costs are billed on a per-therm basis through the Rider 2 Gas Charge. Amounts uncollectible through therms billed under Rider 2 should not be included in the customer charge because of the mismatch that would occur for amounts billed but uncollected on a per-therm basis, versus charging for the uncollectible amounts on a per-customer basis.

The Companies' alternative proposal to recover gas costs through the distribution charge is generally appropriate and is generally in agreement with Staff's proposal, but the specifics of the Company's proposal overcharge some customers for uncollectible gas costs and do not sufficiently charge other customers. The defects in the Companies' proposal are perhaps most apparent with Peoples Gas SC 1N uncollectible gas costs. Peoples Gas would recover $1,432,688 in uncollectible gas costs from SC 1N customers (Exhibit VG 2.3-PGL, column [C], line 2), but total test year gas SC 1N costs are only $14,425,000 (Peoples Gas Ex. VG-1.2, page 2 of 2, column [H], line 24).

$1,432,688 divided by $14,425,000 total gas costs suggests an SC 1N uncollectible rate of 9.93 percent, but the rate of uncollectible SC 1N accounts in the test year was 5.92 percent. (Staff Cross Exhibit 4Grace, page 3 of 3, column [D], line no. 9) Peoples Gas has not explained why the SC 1N uncollectible gas costs rate is 1.677 times the overall SC 1N uncollectible rate (9.93 percent divided by 5.92 percent). Other customer classes at both North Shore and Peoples Gas also show differences in the overall uncollectible accounts rate and the uncollectible gas costs rate. The reduction in the transportation distribution rate and the increase in the sales distribution rate should be calculated according to the method recommended by Staff (ICC Staff Exhibit 19.0, Schedules 19.3-NS and 19.3-PG) rather than the method suggested by the Companies in which uncollectible gas cost rates do not agree with the overall uncollectible rates applicable to each customer service classification.

C. Service Classification Rate Design

1. Uncontested Issues

e. Peoples Gas Service Classification No. 6

The Companies Initial Brief is in error when stating that Staff witness Luth did not have any specific SC 6 rate proposals. (NS-PGL IB, p. 165) Staff agrees with the Companies' indication that Mr. Luth proposed to set SC 6 at cost, but in addition, Staff witness Luth presented SC 6 rates in his rebuttal testimony. (ICC Staff Exhibit 19.0, pp. 20-21, lines 405-414, Schedule 19.1-PG, p. 4 of 11, column [F], lines 91-96; and p. 10 of 11, column [F], lines 186-191) Staff notes that the demand charges shown for sales heating customers and transportation non-heating customers are annual rates which should be divided by 12 to arrive at a monthly charge. (ICC Staff Exhibit 19.0, Schedule

19.1-PG, p. 4 of 11, column [F], lines 93-94; and p. 10 of 11, column [F], line 190) Some of the demand charges are stated on an annual basis in part because SC 6 billing units in the Peoples Gas operating revenue schedules had been shown on an annual basis in direct testimony. (North Shore/Peoples Gas Ex. VG-2.0, p. 48, lines 1049-1061) Rates for SC 6 should be set according to the cost of service developed through Staff's cost of service study, which includes the use of the A&P allocation factor for transmission and distribution system costs, adjusted to the test year revenue requirement authorized by the Commission.

f. Peoples Gas Service Classification No. 8

The Companies Initial Brief is in error when stating that Staff witness Luth did not have any specific rate SC 8 proposals. (NS-PGL IB, p. 165) Staff agrees with the Companies' indication that Mr. Luth proposed to set SC 8 at cost, but in addition, Staff witness Luth presented SC 8 rates in his rebuttal testimony. (ICC Staff Exhibit 19.0, pp. 20-21, lines 405-414, Schedule 19.1-PG, p. 4 of 11, column [F], lines 110-112) Rates for SC 8 should be set according to the cost of service developed through Staff's cost of service study, which includes the use of the A&P allocation factor for transmission and distribution system costs, adjusted to the test year revenue requirement authorized by the Commission.

2. Contested Issues

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

The Companies, CUB and the City of Chicago, and the AG commented upon Staff witness Luth's residential SC 1N and SC 1H rate proposals. (NS-PGL IB, pp. 167-168; CUB/City of Chicago IB, pp. 117-118; and AG IB, p. 139)

CUB/City of Chicago and the AG object to the customer charges that Staff witness Luth proposed, which are based upon the Staff cost of service study results, the revenue requirements proposed by Peoples Gas and North Shore, and a customer charge that is lower than SC 1N and SC 1H customer costs. (ICC Staff Exhibit 19.0, Schedule 19.2-NS, S.C. 1 Non-heating and S.C. 1 Heating columns, *Amount (under) class cost of services*, Customer Charge Revenues line; and Schedule 19.2-PG, S.C. 1 Non-heating and S.C. 1 Heating columns, *Amount (under) class cost of service*, Customer Charge Revenues line) Both CUB/City of Chicago and the AG believe that the customer charges recommended by Mr. Luth are too high and should be lowered, consistent with the position outlined by their joint witness William Glahn. The AG termed Mr. Luth a "strict constructionist" with a "singular focus on recovering a class's cost of service." The AG may disagree with Mr. Luth's rates, but the characterization is excessive. Had Mr. Luth been a strict constructionist with a singular focus on recovering a class's cost of service, the customer charge would have been more than what Mr. Luth proposed because SC 1N and SC 1H customer costs are not fully recovered through the proposed customer charges and distribution charges. Increased customer charges would have required SC 1N and SC 1H customers to pay more than proposed by Staff, even at the lower SC 1N and 1H cost of service Staff proposed compared to the Companies. Furthermore, a lower customer charge relative to class cost of service would have required either:

> a higher distribution charge in the first usage block to recover a greater level of customer costs, or

> an increased subsidy from another customer class to pay for underrecovered SC 1N and SC 1H costs.

Increases to other customer service classifications are also high on a percentage basis under the revenue requirement proposed by Peoples Gas, so requiring further increases from those customers to fund SC 1N and SC 1H costs is unreasonable. (ICC Staff Exhibit 19.0, pp. 18-19, lines 366-371) It is possible that a lower revenue requirement authorized by the Commission would make some increases less difficult. Staff believes, however, that SC 1N and SC 1H should move closer to cost of service, particularly when other customer classes are also facing significant rate increases. (ICC Staff Exhibit 19.0, p. 19-20, lines 387-391)

The Companies err in claiming that Mr. Luth makes no recommendation on SC 1N distribution rates. (NS-PGL IB, p. 169) Mr. Luth presented SC 1N distribution rates in rebuttal testimony. (ICC Staff Exhibit 19.0, Schedule 19. 1-NS, p. 1 of 8, column [F], lines 2-5 and 18-21; p. 4 of 8, lines 2-8 and 22-28; and Schedule 19.1-PG, p. 1 of 11, column [F], lines 2-5 and 18-21; p. 5 of 11, column [F], lines 2-5 and 22-28) Staff's rates are based upon the results of Staff's cost of study at revenue requirements proposed by North Shore and Peoples Gas, with a subsidy from SC 2 to SC 1N and SC 1H having the effect of reducing SC 1N and SC 1H rates. (ICC Staff Exhibit 19.0, pp. 18-20, lines 350-404)

D. Tariffs – Other Tariff Issues

5. Rider 8, Heating Value of Gas Supplied -- Monthly Filing

The Companies continue to propose to change the Rider 8, Heating Value of Gas Supplied filing from a monthly filing to a filing only when the factor changes. (NS-PGL IB, p. 179) The Companies currently file an information sheet and calculation sheet(s) showing any Btu adjustment that may be necessary each month. This monthly filing gives assurance to the Commission that the heating value factor numbers have been reviewed by the Companies each month and that the standard heating value is being maintained. Staff continues to recommend the monthly filing remain in the tariff and rejects the small change in proposed tariff language for Rider 8 pertaining to monthly filings. The Companies' proposed tariff language change is a simple wording change from "each" month to "a" month. Staff does not recommend that it be approved by the Commission. Similarly, Staff does not recommend approval of the proposed addition of the phrase "and remain in effect until superseded by a subsequent filing pursuant to this rider."

X. TRANSPORTATION ISSUES

C. Large Volume Transportation Program

1. Rider FST

No party disagreed with the Companies' agreement to retain Rider FST. (See for example, CNE-Gas IB, pp. 10-11) However, several intervenors described significant objections to the modifications that the Companies propose to Rider FST. The terms the marketers most objected to are the seasonal cycling requirement and the daily restrictions on deliveries and storage usage (primarily injections into storage). The Companies propose to establish Maximum Daily Nominations ("MDN") that equal the previous year's average daily use for the relevant month plus 0.67%xAB. The difference between actual use and deliveries is injected or withdrawn from the AB.

Most marketers argue that the current tariffs have not been shown to be deficient, so there is no need to change them. However, Vanguard accepts the daily restriction with the caveat that it only apply to the summer months. (VES IB, pp. 2-4) In other words, Vanguard proposes to set the nomination restriction at MDQ from November through March. (VES IB, pp. 2-4) Staff agreed to the restrictions and believes that they provide a reasonable restriction on the marketers' ability to use the Companies' systems. (ICC Staff IB, pp. 249-250) These restrictions are also addressed in conjunction with the seasonal restrictions below in X.C.4.

2. Rider SST

The major issue for Rider SST for most marketers is also their rights to access utility storage. In this case, the ICC Staff approves the withdrawal of the Companies' original proposal to vary daily limits by month. (ICC Staff IB, pp. 250-251)

Again, however, the Companies proposed restrictions on how customers and their marketers can use their storage allotment. (NS-PGL IB, pp. 188-191)

Constellation New Energy—Gas Division attacks the new restrictions with a specific example of how they interfere with its business. In particular, it insists that the cycling requirements and daily limits are too restrictive. (CNE-Gas IB p. 11) CNE-G unfavorably compares the current situation to the proposed tariffs. In the current setup, injections equal deliveries (up to the customer's MDQ) less usage. This means that a marketer could deliver its customer's MDQ every day without concern for whether it was exceeding daily injection limits (subject to Critical Days and the AB not being completely filled). However, as proposed by the Companies under the revised Rider SST, injections are limited to 0.67%xAB (this is termed the MDIQ). So deliveries cannot be more than what the customer uses plus the MDIQ. The MDIQ constraint implies that, if actual usage varies significantly from planned, then a planned injection may not occur or it could even become a withdrawal. CNE-G recommends that Rider SST handle daily injection limits as proposed by the Companies in the revised Rider FST using the MDN concept, or remain the same. (CNE-Gas IB p. 11-15) Staff acknowledges that these constraints provide marketers less direct flexibility. Staff first notes that the customer's problem in CNE-G's example is not its injection limits, but CNE-G's ability to nominate on Mondays. (Revised CNEG Zack Cross Ex. 1) But this example may not necessarily provide an accurate picture of the marketer's problem, since most customers will be in pools. Pooling and Super-Pooling mitigate the problem for customers that may exceed injection limits on an individual basis. The utility faces constraints on its storage usage, so that the design of the transportation program should include a reasonable transferral of those rights to transportation customers. (ICC Staff IB, pp. 250-251) Finally, Staff's initial position is that the original restrictions be maintained. (Id., p. 251)

4. Injection, Withdrawal and Cycling Requirements

Staff continues to support the seasonal cycling requirements, since the Companies are faced with portfolios that do have injection and withdrawal limits and these limits vary by Company. It makes sense to transfer these limitations to transportation customers as well. (ICC Staff IB, pp. 250-251) However, all marketers advocate eliminating seasonal cycling requirements. (CNE-Gas 10-11; Multiut IB, pp. 5-7: IIEC IB, pp. 10-11)) CNEG argues that the restrictions don't correspond to utility storage limits.[18] (CNEG IB, pp. 16-27) Staff notes Manlove Field's large share of storage increases the weighted average of storage that needs to be full by the end of

[18] The limits are presented in CNEG Zack Cross Ex. 1 & Ex. 2

November. CNEG refers to unweighted averages, which understates the Companies' problem. (CNEG IB, pp. 17-18) CNE-G proposes that, if the Commission agrees to keep the restriction, that it be reduced to something on the order of 50% rather than 70% (in Peoples Gas' case) or 85% (in North Shore's case), or similar to Nicor, that the restriction on storage being empty be withdrawn. (CNE-Gas IB p. 23)

Several intervenors argue that the new daily injection limits make it difficult or impossible to meet seasonal cycling limits. (CNEG IB, pp. 13-15; Multiut IB, pp. 7-9) Staff agrees, but notes that Super-pooling may also now be available, so that helps marketers plan and prepare to meet customer demands.

CNEG argues that NS and PGL's seasonal restrictions should be the same, since they are balanced together. (CNEG IB, pp. 24-25) Staff disagrees, since the two Companies use a different set of storage services which are accounted for separately. (ICC Staff IB, p. 254)

6. Rider P-Pooling

a. Pool size limits

The Companies argument against higher pool customer limits is summed up in the Companies IB: "The advocates for further increasing pool size claim that the Utilities' concerns about billing and administrative problems from increasing pool sizes are overblown, but none of those advocates have to actually deal with those problems." (NS-PGL IB, p. 194) While that is generally true, this statement avoids the real question at issue here. That is, the Companies' IB does not constitute record evidence that contradicts the plain truth that record-keeping difficulties are not a significant source of costs to the utilities. Though the Companies note that there is no record evidence that costs do not increase substantially above the 200 member pool limit, neither do the Companies show that it does. Staff continues to maintain that there is no significant additional cost to increase pool sizes above 200 customers, and so the Companies should allow unlimited pool sizes.

b. "Super-pooling"

Peoples Gas and North Shore agreed to Super-pooling, but only for the seasonal restrictions and if standalone customers are excluded. (NS-PGL IB, pp. 194-195) The marketers are willing to agree to Super-pooling for limited purposes. They agree to exclude stand-alone customers, but only those that buy from more than one marketer. And while the marketers envision one application that it is limited to is to check cycling requirements, they also advocate that it apply to unauthorized use penalties on Critical Days and imbalance account charges on Supply Surplus Days. CNE-G argues that Peoples and North Shore are "internally inconsistent" when the latter two criteria not included. It also notes that stand-alone customers the most important beneficiary of Super-pooling. It finds no evidence the Companies can't do it or that it is too costly. (CNEG IB pp. 30-32) Vanguard also points out that if the Commission approves cycling requirements, then marketers should be given access to super-pooling. (VES IB, p. 8)

The Staff agreed to not oppose Super-pooling when the Company agreed to it (ICC Staff IB, p. 258) But given the decrease in flexibility that could occur in Riders FST and SST, it is reasonable to include stand-alone customers (but not those with more than one supplier) and to apply Super-pooling to the situations that provide the most benefits to customers such on Critical Days and Supply Surplus Days.

8. Other Large Volume Transportation Issues

d. Receipt of Service Classification, Rider, AB, MDQ, and SSP Information

Marketers advocate that these pieces of information should be given to marketers once the marketer is authorized as agent. (CNEG IB, p. 39) Vanguard also believes that, "The Commission should approve Vanguard's proposal to include the customer's Additional Information [service classification, rider, MDQ, MDN, SSP and AB of a customer] at the time the transportation supplier requests the customer consumption history." (VES IB, p. 9) Further, the transporter will warrant that it has the customer's permission to have it. (VES IB, pp. 9-10) The Companies agree to make information requested by CNE-G available upon enrollment but before the customer is "active and flowing." (NS-PGL IB, p. 201) Staff finds that this is acceptable. (ICC Staff IB, pp. 262)

D. Small Volume Transportation Program (Choices for YouSM or "CFY")

2. Customer Enrollment

a. Customer Data Issues

RGS proposed specific tariff language to release "customer service classification, rider information, customer's Maximum Daily Quantity, customer Selected Standby Percentage, and customer's Allowable Bank at no cost and immediately upon obtaining customer consent." (RGS IB, p. 23) The Companies and the marketers also reached consensus on customer lists, which are to be supplied to marketers [without consent] and updated every six months. (RGS IB, 23-25) However, Staff maintains that no customer information should be provided without prior consent. (ICC Staff IB, p. 261)

The Companies want the Commission to rule that it's OK for them to give customer information to marketers without consent. (NS-PGL IB, p. 208)

The issues become even more sensitive when the issue is customer payment history data. But it remains important to the marketers that they receive the payment information before they begin serving their customers. (RGS IB, 23-25) The Companies want the costs to be borne by marketers under a contract. (NS-PGL IB, p. 208-211) Staff recommends that the Commission not approve release of any information without prior consent. (ICC Staff IB, p. 261)

b. Evidence of Customer Consent

There seems to be broad agreement about what is needed before the Companies can provide sensitive information to marketers. First, the supplier must "warrant and represent" that it has customer permission to receive the data. Second the marketer must hold the Companies harmless from consequences of receiving the information. And third, there must be an 'aud[it]ible verifiable record to confirm consent. (NAE IB, pp. 8-11) RGS also reaches the same broad conclusion. (RGS IB, p. 25) However, whether the marketers/suppliers and Staff have the same understanding of what a "auditable verifiable record" is cannot be determined since parties did not provide any specific examples for the record.

3. Rider SBO

a. Billing Credit

The Companies agreed to provide a credit equal to $0.33 per month. Nicor Advanced Energy argued that the Companies should conduct a cost study to determine the full cost to bill customers. (NAE IB, pp. 11-14) All parties appear to agree that the

$0.33 per bill is appropriate. (NS-PGL IB, p. 212) Staff also believes that a cost study is a reasonable next step to calculate the correct credit.

4. Purchase of CFY Supplier Receivables

Marketers support such a program. NAE discusses such a program, even for SBOs. (NAE IB, pp. 19-20) RGS proposes a program in detail, which RGS argues provide benefits to customers. RGS engages in a series of rebuttals; at one point arguing that the Companies' worry that business risk is shifted to utilities is misplaced. It states that "…POR simply eliminates, rather than shifts, the business risk faced by CFY suppliers under the current treatment of CFY receivables." (RGS IB, p. 35) This is, of course, not correct. Risk just doesn't evaporate. The issue at hand is which entity assumes how much of it and the compensation it receives for assuming it. (ICC Staff IB, p. 264)

The Companies (NS-PGL IB, pp.214-217) and Staff (ICC Staff IB, p. 264) both recommend that the Commission reject the program.

XII. CONCLUSION

Staff respectfully requests that the Illinois Commerce Commission approve Staff's recommendations in this docket.

Respectfully submitted,

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Illinois Commerce Commission

October 23, 2007

STAFF REPLY BRIEF ATTACHMENT A

IN THE MATTER OF THE PETITION OF NEW JERSEY NATURAL GAS COMPANY FOR THE ANNUAL REVIEW AND REVISION OF ITS BASIC GAS SUPPLY SERVICE (BGSS) FOR FISCAL YEAR 2007

DOCKET NO. GR06060415

New Jersey Board of Public Utilities

2006 N.J. PUC LEXIS 101

September 29, 2006, Dated

CORE TERMS: decrease, therm, customer, effective, provisional, residential, periodic, methodology, annual, refund, subject to refund, public interest, sales tax, tax rate, over-recovery, calculation, decreasing, entirety, heating, Office of Administrative Law, original request, public notice, approve, calculated, authorize, monthly, modify, notice, impair, audit

PANEL: **[*1]** JEANNE M. FOX, PRESIDENT; FREDERICK F. BUTLER, COMMISSIONER; CONNIE O. HUGHES, COMMISSIONER; JOSEPH L. FIORDALISCO, COMMISSIONER; CHRISTINE V. BATOR, COMMISSIONER

OPINION: ENERGY

DECISION AND ORDER APPROVING STIPULATION FOR PROVISIONAL BGSS RATES

BY THE BOARD

In accordance with the New Jersey Board of Public Utilities ("Board") January 6, 2003 Order in Docket No. GX01050304, New Jersey Natural Gas Company ("Petitioner," "Company," or "NJNG") filed its annual Basic Gas Supply Service ("BGSS") petition with the Board on June 1, 2006. The Company's petition sought to: (1) decrease its periodic BGSS rate applicable to those customers subject to the Periodic BGSS Pricing Mechanism from $ 1.2597 per therm including taxes to $ 1.1493 per therm including taxes; and (2) modify its BGSS interest calculation methodology, whereby in lieu of interest being calculated on a monthly basis at the Company's authorized overall rate of return, as done under the current methodology, the interest rate used for the calculation would be the prevailing SBC rate. The Company's proposed adjustment to its Periodic BGSS rate would result in a decrease of approximately 6.6 percent or $ 11.04 per month after tax, **[*2]** to the average NJNG residential heating customer using 100 therms monthly. The BGSS year is for the twelve months ended September 30, 2007.

Pursuant to P.L. 2006, c.44, the New Jersey sales tax rate increased from 6 percent to 7 percent effective July 15, 2006. Due to the enactment of P.L. 2006, c.44, NJNG seeks to decrease its Periodic BGSS rate by $ 0.1115 per therm including taxes, effective October 1, 2006 thereby decreasing NJNG's current after tax rate of $ 1.2716 per therm to $ 1.1601 per therm after tax. The resulting decrease to the average NJNG residential heating customer using 100 therms monthly is $ 11.15. The annual revenue decrease to the Company would be approximately $ 53.4 million.

The Company also provided preliminary notice to the Board, in its petition, that it intended to issue refunds in September, 2006 to its Periodic BGSS customers, based upon Periodic BGSS volumes consumed by individual customers during the period of February 1, 2006 through

August 31, 2006. On August 25, 2006, the Company notified the Board that it would actually refund a total of $ 22.5 million pre-tax BGSS recovery to all periodic BGSS customers based upon their periodic BGSS usage **[*3]** for the period from February 1, 2006 to July 14, 2006. The pretax refund per therm amounts to $ 0.1137. The estimated average refund per customer amounts to $ 52.57.

Following a review by, and subsequent discussions among representatives of NJNG, Rate Counsel, and Board Staff, the only parties to this proceeding (collectively, "the Parties") on August 17, 2006, the Parties entered into the attached Stipulation for Provisional BGSS Rates ("Stipulation"). The attached Stipulation solely addresses establishing new provisional BGSS rates for the Company; the remaining issues will be addressed in the normal course of business. Among the provisions in the Stipulation is the agreement that additional time is needed by the Parties to allow for a full and comprehensive review of the Company's 2006 BGSS petition. In addition the Parties recommend that pending their review and final determination by the Board, it would be reasonable for the Board to authorize on a provisional basis, subject to refund and interest on any net over-recovered BGSS balance, the Company's proposed decrease in its BGSS rates. The Parties agree that a price decrease in NJNG's BGSS rates, on a provisional basis, is **[*4]** reasonable at this time so that NJNG's customers may receive the benefit of the lower BGSS price. The attached Stipulation does not impair the Board's future consideration of the Company's original request to modify the standard BGSS interest calculation methodology.

The Parties agree that the Company's above request for provisional implementation of its Periodic BGSS rates should be effective October 1, 2006. The parties agree that the above-referenced BGSS rate filing will be transmitted to the Office of Administrative Law ("OAL"), with an opportunity for full review at the OAL and subsequent final Board approval.

On July 13, 2006, two public hearings in this matter were held in Freehold, New Jersey. One hearing was held in the afternoon and the other was held in the evening. n1 The public hearings were preceded by notices in newspapers of general circulation throughout the Company's service territory. The public notice also advised customers that the Board granted the Company the discretion to self-implement an increase in its BGSS rates to be effective December 1<st> of this year and/or February 1<st> of next year, with each increase capped at 5% of the total NJNG residential **[*5]** bill. The public notice also stated that the Company is permitted to decrease its BGSS rate at any time upon two weeks' notice to the Board and Rate Counsel. No members of the public appeared at the public hearings to provide comments related to the Company's request to decrease its Periodic BGSS rates.

n1 The public hearings in this matter were held together with public hearings in another pending NJNG matter. *In the Matter of the Petition of New Jersey Natural Gas Company for the Implementation of a Conservation and Usage Adjustment*, BPU Docket No. GR05121020.

DISCUSSION AND FINDINGS

The Board, having carefully reviewed the record to date in this proceeding and the attached Stipulation, HEREBY FINDS that, subject to the terms and conditions set forth below, the Stipulation is reasonable, in the public interest and in accordance with the law. Accordingly, the

Board HEREBY ADOPTS the Stipulation as its own, as if fully set forth herein and HEREBY APPROVES on a provisional basis, the Company's **[*6]** implementation of a decrease in the Company's after-tax per-therm BGSS rate to $ 1.1601 effective October 1, 2006. Any net over-recovery on the BGSS balance, at the end of the BGSS period, shall be subject to refund with interest.

The Board HEREBY ORDERS that this docket be forwarded to the OAL for full review and an Initial Decision and then returned to the Board for a Final Decision. The Company is HEREBY DIRECTED to file the appropriate tariff sheets conforming to the terms and conditions of this Order within ten (10) business days from the effective date of this Order. The Company's gas costs will remain subject to audit by the Board. This decision and Order shall not preclude nor prohibit the Board from taking any actions determined to be appropriate as a result of any such audit.

DATED: 9/29/06

BOARD OF PUBLIC UTILITIES

BY:

JEANNE M. FOX

PRESIDENT

FREDERICK F. BUTLER
COMMISSIONER

CONNIE O. HUGHES

COMMISSIONER

JOSEPH L. FIORDALISCO
COMMISSIONER

CHRISTINE V. BATOR

COMMISSIONER

STIPULATION FOR PROVISIONAL RATES

APPEARANCES:

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Babette Tenzer, Esq. and Anne-Marie Shatto, Esq., Deputy Attorneys General. for the Staff of the New Jersey Board of Public Utilities (**Zulima Faber, Esq.,** Attorney General of New Jersey)

TO: THE NEW JERSEY BOARD OF PUBLIC UTILITIES

1 New Jersey Natural Gas Company (NJNG) tiled a petition in Docket No GRO6060415 on June , 2006 Through its petition, NJNG requested the New Jersey Board of Public Utilities (BPU or Board) to accept NJNG's annual reconciliation filing for its Basic Gas Supply Service (BGSS). and approve the Company's related request to decrease the periodic BGSS rate applicable to those customers subject to the Periodic BGSS Pricing Mechanism by $ 0.1104 per therm after tax, effective September 1, 2006, decreasing the after tax rate of $ 1. 2597 per therm to $ 1.1493 per therm. This Change represent a decrease of approximately 6.6 percent for the average residential heating customer using 100 therms per month The projection of NJNG's under-/over-recovery of natural gas costs., was based on market conditions

as of the time of the June 1, 2006 filing with a proposed **[*8]** one-year BGSS recovery period.

2. A public hearing on the petition was held on July 13. 2006, in Freehold Borough. New Jersey. No members of the public appeared to provide comments relating to NJNG's request to decrease its Periodic BGSS rate.

3. Representatives of NJNG, Board Staff and the Department of the Public Advocate, Division of Rate Counsel (Rate Counsel) (the Parties). the only Parties to these proceedings, have discussed certain matters at issue in these proceedings. As a result of those discussions, the Parties, have determined that additional time is needed to complete the review of NJNG's proposed BGSS rate and other aspects of the Company's BGSS petition. However, the Parties also agree that a BGSS price decrease, on a provisional basis. is reasonable at this time so that NJNG's customers may receive the benefit of the lower BGSS price.

4 Pursuant to P.L. 2006, c.44, the sales tax rate in New Jersey increased from 6 percent to 7 percent as of July 5, 2006. In light of that, this Stipulation reflects price changes based on a state sale tax of 7 percent. With the sales tax adjusted, NJNG is seeking to decrease the BGSS rate applicable to those customers subject to the **[*9]** Periodic BGSS Pricing Mechanism by $ 0. 15 per therm after tax. effective October, 2006, decreasing the after tax rate of $ 1.2716 per therm to $ 1.1601 per therm.

<1> The June 1 filing also included testimony, schedules and data that are responsive to and consistent with the Minimum Filing Requirements (MFRs) for annual BGSS filings, pursuant to the Board's generic BGSS Order in Docket No. GXO1050304.

5 Accordingly. the Parties stipulate and agree that pending the conclusion of any further review and discussions among the Parties, and pursuant to *N.J.S.A. 48:2-21.1*. it would be both reasonable and in the public interest for the Board to authorize the proposed decrease in the periodic BGSS rate to $ 1.1601 per therm after tax (instead of $ 1.1493 per therm after tax as in the June 1 filing), effective as of October 1. 2006, or as of a later date should the Board so decide. This price decrease is on a provisional basis, subject to refund with interest on any net over-recovery, an opportunity for a full review at the Office of Administrative Law if necessary, and final approval by the Board. The stipulated change represents an overall **[*10]** decrease from the rates currently in effect of approximately 6.6%. or $ 11.15 per month for a typical residential sales service customer using 100 therms per month. This action will lead to a decrease in annul revenue to NJNG of approximately $ 53.4 million

6. In the June filing the Company also requested approval to implement a limited modification to the current manner in which BGSS interest is calculated. Since the Parties have not yet had the opportunity to discuss this Stipulation in no way impairs the Board's future consideration of Company's original request for the modified interest method to be effective as of October 1, 2006.

7. This Stipulation represents a mutual balancing of interests, contains interdependent provisions and, the therefore, is intended to be accepted and approved in its entirety In the event any particular aspect of this Stipulation is nor accepted and approved in its entirety by the Board, any Party aggrieved thereby shall not be bound to proceed with this Stipulation and shall have the right to litigate all issues addressed herein to a conclusion. More particularly, m the event this Stipulation is not adopted if its entirety by the Board, in any applicable **[*11]** Order(s). then any Party hereto is free to pursue its then available legal remedies with respect to all issues addressed in this Stipulation as though this Stipulation had not been signed

8. It is the intent of the Parties that the provisions hereof be approved by the Board as being in the public interest. The Parties further agree that they consider the Stipulation to be binding on them for all purposes herein.

9. It is specifically understood and agreed that this Stipulation represents a negotiated agreement and has been made exclusively for the purpose of these proceedings. Except as expressly provided herein, neither NJNG. the Board, its Staff, nor Rate Counsel shall be deemed to have approved agreed to or consented to any principle or methodology

underlying or supposed to underlie any agreement provided herein.

WHEREFORE, the Partners hereto do respectfully submit this Stipulation and request that the Board issue a Decision and Order approving it in its entirely in accordance with the terms hereto, as soon as reasonably possible.

NEW JERSEY NATURAL GAS

PETITIONER

TRACEY THAYER, ESQ

New Jersey Natural Gas

DEPARTMENT OF THE PUBLIC ADVOCATE

DIVISION OF [*12] RATE COUNSEL

SEEMA M. SINGM, ESQ, DIRECTOR.

SAKAH STEINDEL, ESQ.

ASSISTANT DEPUTY RATEPRAYER ADVOCATE

STAFF OF THE NEW JERSEY BOARD OF PUBLIC UTILITIES

ZULIMA FARBER, ATTORNEY GENERAL OF NEW JERSEY

BABETE TENZER, ESQ ANNE MARIE SHATTO, ESQ.

DEPUTY ATTORNEYS GENERAL

Date August 17, 2006

Legal Topics:

For related research and practice materials, see the following legal topics:
Administrative LawAgency AdjudicationReview of Initial Decisions