STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

North Shore Gas Company	)	ICC Docket No. 07-0241
	)	
Proposed general increase in	)	
rates for gas service	)	
	)	
Peoples Gas Light & Coke Company	)	ICC Docket No. 07-0242 (cons.)
	)	
Proposed general increase in	)	
rates for gas service	)	

REPLY BRIEF ON EXCEPTIONS
<u>OF THE PEOPLE OF THE STATE OF ILLINOIS</u>

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NOW COME the People of the State of Illinois ("the People"), by Lisa Madigan, Attorney General of the State of Illinois, and pursuant to Part 200.830 of the Illinois Commerce Commission's ("the Commission") rules, 83 Ill.Admin.Code Part 200.830, hereby file their Reply Brief on Exceptions to the Brief on Exceptions ("BOE") and Exceptions filed by the Peoples Gas Light & Coke Company ("PGL" or "Peoples Gas") and North Shore Gas Company ("North Shore") to the Proposed Order issued by the Administrative Law Judges in the above-listed docket on November 26, 2007.

I. Introduction

The Companies Brief on Exceptions includes a disconcerting level of inaccurate assertions of the record evidence in this docket, as well as a deeply flawed discussion of Illinois case law to support its rider proposals. Having failed to establish either an evidentiary or legal basis for the five unorthodox rider proposals proposed, the Companies apparently abandoned their bare-bones approach in their Initial and Reply briefs to discussing the legal issues involved, and now attempt in their Brief on Exceptions to cobble together a purported legal rationale to support approval of these rider mechanisms. This eleventh-hour rationale, however, is completely erroneous, as discussed further below.

In addition, the Companies' exceptions to several conclusions in the ALJPO on revenue requirement and cost of service issues misstate the record evidence and ignore relevant Commission precedent. These arguments, too, should be rejected. For all of the reasons stated below, the Commission should reject the arguments presented by the Companies in their Brief on Exceptions and Proposed Exceptions and enter an Order in accordance with the recommendations of the People of the State of Illinois in their Brief on Exceptions, as well as the AG Initial and Reply briefs.

II. RATE BASE

A. Reserve for Accumulated Depreciation and Amortization

The Proposed Order diminishes the significance of Staff's decision to withdraw its opposition to GCI's proposed adjustment to the reserve for accumulated depreciation, stating that this reversal is "of no consequence". PO at 17. Staff's Reply Brief did not explain this reconsideration, but its Brief on Exceptions offered reasoning that should overcome the ALJPO's dismissal.

Staff correctly observes that it is the calculation of *net* plant-in-service that is necessary to accurately reflect the costs and revenues for the period in which rates will be in effect. Staff BOE at 3. It is this aggregate calculation that the Companies' reject when they advance the argument that updating the accumulated depreciation on embedded plant converts the historical test year to a future test year. But as Staff additionally recognizes, "…the Companies have already brought the test year into the future by updating plant-in-service through September 30, 2007." *Id.* Staff's analysis sheds light on the rationale behind Part 287.40. The rule contemplates net calculations, not piecemeal adjustments, through the requirement that updates made through *pro forma* adjustments be made to reflect *all* changes within a given accounting category. The rationale behind the rule is as easily understood as is Staff's explanation: without accounting for all changes in rate base for a given period, *pro forma* rate base adjustments will not reflect a utility's total rate base.

The Commission should take particular notice of Staff's straight-forward acknowledgment that understanding of the very complex issues facing regulators is a constantly evolving process, and adopt GCI witness Effron's accumulated depreciation adjustment.

B. OPEB Liabilities and Pension Asset/Liability

The ALJPO correctly concluded that the amounts collected in rates from ratepayers but not actually expended for the pension costs covered by the rates is a source of cost-free capital, and accordingly should not be included in the Companies' rate base. ALJPO at 35. The Companies' except to the ALJPO's recommendation regarding their accrued OPEB liability and insist that the fact that the Companies made contributions to these plans during the test year should be determinative of whether to include these amounts in rate base. PGL/NS BOE at 14-17. This insistence continues in spite of the fact that, as both Staff witness Pearce and GCI witness Effron point out, ratepayers have supplied these funds for future obligations and such cost-free capital should be recognized in the revenue requirement as a reduction from rate base. GCI Ex. 2.0 at 13; ICC Ex. 14.0 at 21-22.

The only other arguments the Companies have marshaled in their Brief on Exceptions against this treatment are the claims that ratepayers have benefited from the utilities' contributions to the pension plan and that the Commission approved the inclusion of a pension asset in rate base in a case in which the inclusion was not a contested issue. PGL/NS BOE at 15-16. Whether ratepayers benefited from these payments or whether any intervenors mounted an objection to a utility accounting proposal is irrelevant to the controlling factor in rate base treatment: the source of the funds.

The Utilities for the first time cite the Commission's decision in *In re Central Illinois Light Co.*, ICC Docket No. 94-0040, Order of December 12, 1994 ("*CILCO*") as new support for their position that the aforementioned pension assets should be included in the Companies' rate base. PGL/NS BOE at 4. This citation misses the mark because, as the Companies themselves note, the inclusion of the pension asset was not a contested issue.

In the instant docket, no party challenged the fact that these are ratepayer-funded sources of capital. The same arguments that apply to the removal from rate base of the OPEB liability support identical treatment of pension assets and liabilities. As recommended in the AG's Brief on Exceptions, these amounts of ratepayer-supplied funds should be removed from rate base.

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III. OPERATING INCOME – Incentive Compensation Expenses

The Companies' exceptions to the ALJPO's incentive compensation adjustments still lack the specificity needed to justify the inclusion of all incentive compensation program costs and expenses in the Utilities' proposed revenue requirement. PGL/NS BOE at 18. Typically, the Commission has disallowed incentive compensation from utility revenue requirements except in instances in which the utility demonstrated that its incentive compensation plan reduced expenses and created greater efficiencies in operations. *See Illinois Power Company – Proposed Increase in Rates*, ICC Docket No. 01-0432, Order of March 28, 2002 at 42-43; *Nicor Gas Company – Proposed Increase* *in Rates*, ICC Docket No. 04-0779, Order of September 20, 2005 at 44-46; *AmerenCILCO, AmerenCIPS, AmerenIP – Proposed Increase in Rates*, ICC Docket Nos. 06-0700, 06-0071, 06-0072 (cons.), Order of November 21, 2006 at 72. The mere possibility that benefits may be passed on to consumers is insufficient proof of this standard. Neither Peoples nor North Shore presented persuasive testimony in this docket to demonstrate tangible, quantifiable benefits. GCI Ex. 5.0 at 10. Both Staff witness Bonita Pearce and GCI witness Effron recommended removal of incentive compensation costs from the 2006 test year of each Company. ICC Ex. 1.40 at 4; GCI Ex. 2.0 at 25-26.

The AG agrees with Staff's observation that the makeup of the TIA and IPB plans would permit the incentive criteria for these plans to change from year to year, calling into question whether they would provide consistent tangible benefits to ratepayers. Staff BOE at 22-23. The companies' exceptions contain no compelling evidence of tangible, quantified benefits in this regard and cannot constitute the basis for Commission findings on this issue. The Commission should revise the ALJPO to disallow the TIA and IPB plans, along with the incentive compensation plans that were denied expense recovery.

IV. RATE OF RETURN -- Return on Common Equity

The People of the State of Illinois incorporate by reference the arguments presented in the CUB/City of Chicago Reply Brief on Exceptions that respond to the Companies' arguments on this issue at pages 20-37 of their BOE.

V. RIDER VBA

A. The Companies' Brief on Exceptions Makes Blanket Misstatements About When Riders Are Permissible Under Illinois Case Law.

In a belated attempt to revive their Rider VBA proposal, the Companies for the first time in this case articulate a legal theory of sorts that argues that Commission authority to approve riders is unlimited, as long as "the item for recovery is part and parcel of a 'rate' established by the Commission." PO at 45. The Companies boldly assert that "where an adjustment mechanism is a rate schedule approved by the Commission which contains a mathematical formula for making future changes in the rate schedule, it is not unlawful under the Act." PGL/NS BOE at 46. In asserting this interpretation of Illinois case law, the Companies rely almost entirely upon the 1958 case of *City of Chicago v. Illinois Commerce Comm'n,* 13 Ill.2d 607 (1958) ("*City I")*, and argue that the Supreme Court in that decision gave the Commission unambiguous authority to adopt automatic rate adjustment mechanisms, i.e. riders, without articulating any restrictions. The Companies further argue that no case decided since *City I* limited items for recovery under riders to "costs." Instead, the Companies argue, "(t)he dispositive fact is that the item for recovery is part and parcel of a "rate" established by the Commission." PGL/NS BOE at 45.

This flawed, completely inaccurate take on Illinois case law and Commission authority to adopt riders should be rejected out of hand, as discussed below.

1. The Companies' Assertion That Any Rate With A Mathematical Formula Constitutes A Permissible Rider Ignores Both the Public Utilities Act and Illinois Case Law.

A review of the *City I* ruling, and subsequent Illinois case law interpreting the ratemaking rules of the Public Utilities Act quickly reveals that the Court in *City I* articulated no such unlimited authority. In that case, which approved the use of a rider for the recovery of purchased natural gas costs, the Court concluded that "the Public Utilities Act of Illinois vested in the commission the power to authorize an automatic adjustment clause to be filed in a rate schedule *in the proper case*." *City 1,* 13 Ill.2d at

614 (emphasis added). The Court carefully analyzed why the purchased gas rider constituted "the proper case". The Court specifically acknowledged, for example, the authority of the Federal Power Commission ("FPC") to oversee the rates charged to utilities for natural gas, and rejected the argument that the Commission has the authority to determine the reasonableness of the commodity rates, having concluded that the power to fix rates for natural gas transported and sold in interstate commerce was vested by congressional act to the exclusive jurisdiction of the FPC. *Id.* at 616. Indeed, the *City I* court noted that until the Commission approved the automatic adjustment clause for purchased gas costs, it was the practice of the Commission to allow rate increases based upon an anticipated increase in the cost of natural gas to go into effect without suspension. *Id.* at 618. Further, the Court recognized the substantial proportion of the Company's overall expenses -- 46% at that time – that these commodity costs represented, and that the Company purchased this commodity on the wholesale market at prices fixed by the FPC. *City I* at 614. It was within these factual constraints, then, that the Court held that the approved purchased gas adjustment rider "is simply an addition of a mathematical formula to the filed schedules of the Company under which the rates and charges fluctuate as the wholesale cost of gas to the Company fluctuates." *Id.* at 613.

No such analogy can be made with Rider VBA, notwithstanding the Companies argument that "where an adjustment mechanism is a rate schedule approved by the Commission which contains a mathematical formula for making future changes in the rate schedule, it is not unlawful under the Act." PGL/NS BOE at 46. Taken to its illogical conclusion, any rider proposal offered by a utility that included a mathematical formula that automatically adjusted rates would constitute an appropriate rider.

As discussed below, lost revenues due to declining usage per customer is in no way comparable to the wholesale purchased gas costs incurred by the Companies, which prior to the *City I* ruling were always passed through to natural gas delivery customers without suspension. Both the *City I* case and subsequent Illinois court rulings reject the view that Rider VBA passes legal muster.

2. Purchased Gas Adjustment Clause Riders Share No Similarities To Revenue Decoupling Proposals.

The Companies continue their simplistic analysis of the *City I* decision and the rate effect of Rider VBA with this apples-to-oranges comparison: the fact that *City I* involved consideration of a type of rider being proposed for the first time in Illinois and Rider VBA's decoupling mechanism is likewise a first-time request in Illinois makes the two "strikingly similar." PGL/NS BOE at 48. This hollow reasoning borders on the absurd. Clearly, the Rider VBA legal analysis requires more evidence of similarities between Rider VBA and riders that have been affirmed as appropriate by Illinois courts than the Companies' observation that both were "new" proposals.

The Companies attempt to construct other "similarities" between the *City I* fact pattern and the case at hand. The Companies state, for example, that the subject of the *City I* rider was wholesale natural gas prices, which were fixed by the Federal Power Commission, "just as the margin revenue levels in the instant proceeding will have been fixed by the Commission." PGL/NS BOE at 48. This, too, is an inapt, hollow argument. Again, a Company's single, largest expense item, the price of which is established by another governmental body by congressional mandate and traditionally passed through to ratepayers, is in no way comparable to Rider VBA's artificial benchmark of guaranteeing a Company-specified level of revenues per customer to address what the Companies amorphously refer to as their "business challenges."

Speaking of which, the Companies further allege that in both the *City I* decision and the instant case, the Commission will have responded to alleged "business challenges", and posit this as another similarity between this case and the *City I* fact pattern. However, finding a preferred method of recovering wholesale gas costs – the utility's single largest expense item – versus guaranteeing the Companies a specified level of revenues *per customer* when the record evidence revealed that the alleged "business challenges" do not exist is hardly similar. The record evidence, in fact, showed that any so-called business challenge was being aptly addressed under traditional rate of return regulation. *See* AG Initial Brief at 53-67. For example, Peoples Gas earned around or significantly above its authorized return on common equity in eight of the last 12 years. AG Cross (Borgard) Ex. 3. PGL's actual earned return on equity has been consistently positive, staying within a range from 10.16 to 14.52 percent throughout the nine-year period 1995-2003. GCI Ex. 1.0 (Brosch) at 18. Similarly, North Shore has consistently earned stable returns, with ROEs ranging from 10.43 to 14.13 percent in all years 1995 through 2005.[1]

Most important, these exceptional earnings occurred while actual usage per customer – the benchmark that the Companies request Rider VBA reflect – was persistently below the normalized use per customer set in the prior rate case. *See* PGL Ex. LTB-1.2, NS Ex. LTB- 1.2, AG Cross (Borgard) Ex. 3. Additionally, PGL/NS witness Feingold confirmed that these exceptional earnings occurred despite reported declines in margin revenues in these years. Tr. 1307-1308. The Companies simply

[1] The exception for North Shore was the year 2000, when its ROE was 5.38 percent. GCI Ex. 1.0 at 19.

provided no basis for the notion that "business challenges" exist, let alone require the extraordinary ratemaking treatment inherent in Rider VBA.

The Companies further assert that the Court in *City I* took notice of actions taken in other states with respect to adoption of automatic rate adjustment mechanisms for the recovery of purchased gas costs (PGL/NS BOE at 49), just as PGL and North Shore implore this Commission in the instant case to observe approval of decoupling mechanisms in other states. But as noted in both the AG and Staff briefs, assertions about action in other states are strawman arguments. First, only 11 out of 50 states have adopted any kind of decoupling mechanisms. Eleven states is hardly a tidal wave of authority. Second, no evidence or detail was provided to indicate that any of these approved decoupling mechanisms operates or is constructed like the PGL/North Shore-proposed Rider VBA.

Third, the Companies fail to mention that many of the approved decoupling orders were the result of settlement. Specific discussions in Mr. Feingold's testimony of a state approving a decoupling rider involved, in each instance, approval by *settlement* between the utility, a PSC staff and intervening parties, with a quid pro quo of specific commitments toward conservation and energy efficiency programs. Tr. 1286, 1288, 1289, 1291-1296. *Compare* PGL Ex. RAF-2.0 45-46, *In the Matter of Northwest Natural Gas – Investigation Regarding Possible Continuation of Distribution Margin Normalization Tariff,* Order of August 25, 2005, Attachment A (Stipulation). Finally, Mr. Feingold admitted in cross-examination that he does not keep track of commission decisions rejecting decoupling proposals, rendering his assertions about trends wholly one-sided. *See* AG Cross Ex. 5. In fact, decoupling proposals were recently rejected in the states of New Mexico and Washington. In short, this Commission should evaluate Rider VBA based on the record evidence and Illinois case law, not the claims of the Companies about regulatory trends.

Finally, the Companies assert in what can only be described as a bizarre, irrelevant observation, that the rider approved in *City I* "occurred in a case specific to Peoples Gas and not in a generic proceeding", and that the Companies here seek approval in their individual rate cases. PGL/NS BOE at 50. These facts are about as relevant as the Companies' earlier observation that both cases involved "new" proposals. The bottom line is that the *City I* court's approval of PGA riders is in no way similar to the Companies' proposal to approve Rider VBA, which is nothing more than a request to charge ratepayers more when the meaningless standard of "usage per customer" declines.

3. The Companies Make Numerous Misstatements About the ***Finkl*** Ruling and Other Subsequent Decisions Addressing Permissible Rider Recovery That Should Be Rejected.

As noted in the AG Brief on Exceptions, the First District Appellate Court has specifically rejected the notion of requiring ratepayers to reimburse a utility for revenues lost due to energy efficiency and conservation measures through a rider mechanism. *A.Finkl & Sons Co. v. Illinois Commerce Comm'n,* 250 Ill.App.3d 317 (1st Dist. 1993). The notion of reimbursing Peoples Gas and North Shore for declining revenues associated with, among other phenomena, energy efficiency and conservation, is at the heart of the Companies' decoupling proposal.

Moreover, as correctly stated at page 145 of the PO, the common thread in decisions allowing rider treatment is that the rider recovery at issue in each case addressed a "burden" on a utility imposed by *costs* it cannot avoid or control. As noted in the *Finkl* case, "Riders are useful in alleviating the burden imposed upon a utility in meeting *unexpected, volatile* or *fluctuating* expenses." *Finkl*, 250 Ill.App.3d at 327 (emphasis in original). Again, given that Rider VBA would recover per customer lost revenues, it simply does not qualify for rider treatment under this standard.

Yet, the Companies' tortured reading of the *City I* decision ignores and misstates subsequent Illinois case law which elaborated on the appropriate criteria for rider recovery and the ratemaking rules that must not be violated under the Public Utilities Act. For example, the Companies amazingly assert that the First District Appellate Court in the *Finkl* case never addressed, in either argument or ruling, the fact that the rider at issue in that case, like Rider VBA in this case, would recover lost revenues associated with energy efficiency programs. PGL/NS BOE at 43.

As noted in the AG Brief on Exceptions, the *Finkl* case, in which the First District panel *specifically* rejected the notion of requiring ratepayers to reimburse a utility for revenues lost due to energy efficiency and conservation measures, is squarely on point. In addition to recovering the expenses associated with the provision of demand side management (energy efficiency) program costs, the rider at issue in *Finkl,* named Rider 22, also would have authorized Commonwealth Edison to charge ratepayers for lost revenues associated with demand-side management activities, similar to the Companies' request in this docket to adjust rates each month when margin revenues fall below a revenue per customer baseline established in this Order. The *Finkl* Court noted that the Rider 22 recovery of lost revenues associated with the DSM programs "fails to take into consideration Edison's aggregate costs and revenues, which is also the vice inherent in this revenue recapture…" *Finkl* at 328. As noted in the AG Brief on Exceptions[2], The Court flatly rejected the notion of making a utility whole for lost revenues associated with conservation or DSM programs:

> Requiring ratepayers to bear the expense of services they avoid due to conservation or DSM programs is not only incredible, but runs afoul of basic ratemaking principles. The Act requires that rates be set which 'accurately reflect the long-term cost of such services and which are equitable to all citizens.' (Ill.Rev.Stat.1989, ch. 111 2/3, par. 1-102 (now 220 ILCS 5/102 (West 1992))(section 1-102).) Both in *Illinois Bell Telephone Co. v. Illinois Commerce Comm'n* (1973), 55 Ill.2d 461, 483, 303 N.E.2d 364, and in *Candlewick Lake Utilities Co. v. Illinois Commerce Comm'n* (1983), 122 Ill.App.3d 219, 227, 460 N.E.2d 1190, the courts have asserted that ratepayers are not to pay certain costs unless they directly benefit from them. The lost revenue charge here does not reflect the cost of providing electric service, does not reflect a cost that benefits ratepayers and, further, does not reflect a cost that benefits ratepayers and, further, adds to Edison's revenues without regard to whether Edison's demand or revenues increased because of factors unrelated to DSM programs. This is yet another basis for reversal.

Id. at 329.

Given the clear direction provide by the *Finkl* Court in its specific rejection of ratepayers compensating a utility for lost revenues arising from energy efficiency and other measures, the Companies' erroneous assertion that the *Finkl* decision "did not seem concerned at all that Rider 22 involved lost revenues" is reckless, if not disingenuous.

B. Contrary To The Companies' Assertion, Rider VBA Violates Several Ratemaking Precepts.

In their attempt to convince the Commission that Rider VBA is legal, the Companies offer simplistic interpretations of the Public Utilities Act's prohibition against single-issue ratemaking and the Commission's test year rules. For example, the Companies' assertion at the top of page 53 that "the margin revenues recovered under

[2] *See* AG Brief on Exceptions at 25-26.

Rider VBA" do not violate the prohibition against single-issue ratemaking "because they do not have any impact whatsoever on the Utilities' overall revenue requirements or rates of return" (PGL/NS BOE at 53) is simply untrue. Their additional assertion that the rate adjustments that would be triggered under Rider VBA "will never change the Utilities revenue requirement" obfuscates the rule against single-issue ratemaking. As discussed below, the Companies' interpretation of Illinois case law addressing rider recovery of utility expenses ignores the plain fact that Rider VBA will adjust customer rates on a monthly basis based on usage per customer variations, in violation of the prohibition against single-issue and retroactive ratemaking, as well as the Commission's test year rules.

1. Rider VBA Violates The Act's Prohibition Against Single-Issue Ratemaking.

Rider VBA would adjust rates on a monthly basis based on a single operating income element, in this case revenues per customers, without examining other expense and revenue elements in the revenue requirement formula. The revenue changes triggered by Rider VBA constitute classic single-issue ratemaking. In *Finkl,* the court ruled that the rider at issue violated the prohibition against single-issue ratemaking, the rule that prohibits the Commission from considering changes to components of the revenue requirement in isolation, and noted that the costs were recoverable through the usual base rate mechanism. *Finkl, 250 Ill.App.3d at 327,* citing *Business and Professional People for the Public Interest v. Illinois Commerce Comm'n,* 146 Ill. 2d. 175, 244, 585 N.E.2d 1032 (1991) ("*BPI II").* Consideration of one item in the revenue formula in isolation risks understatement or overstatement of the revenue requirement.

Id. The Illinois Supreme Court, in addressing the issue of single-issue ratemaking in *BPI II,* stated*:*

> The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the *aggregate* costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Often times a change in one item of the revenue formula is offset by a corresponding change in another component of the formula. For example, an increase in depreciation expense attributable to a new plant *may* be offset by a decrease in the cost of labor due to increased productivity, or by increased demand for electricity. …In such a case, the revenue requirement would be overstated if rates were increased based solely on the higher depreciation expense without first considering changes to other elements of the revenue formula. Conversely the revenue requirement would be understated if rates were reduced based on the higher demand data without considering the effects of higher expenses.

BPI II, 146 Ill.2d at 244-45.

The Companies' proposal to selectively adjust rates on a going-forward basis to ensure a designated level of *revenues per customer* – a barometer not incorporated in any interpretation of the Public Utilities Act's requirement for the establishment of just and reasonable rates – without examining whether overall revenues have increased or whether expenses have decreased to offset revenue losses, violates the prohibition against single-issue ratemaking.

While the Illinois Supreme Court upheld the Commission's approval of rider recovery of coal tar clean-up expenses in *Citizens Utility Board v. Illinois Commerce Comm'n*, 166 Ill.2d 111, 651 N.E.2d 1089 (1995), the Court made clear that the prohibition against single-issue ratemaking did not apply in that case because the Commission's approval of a rider for the coal tar clean-up expenses occurred outside of a general rate case.[3] *Id.* at 137-138. Given the fact that this *is* a general rate case, the

[3] The Court in *Citizens Utility Board* also affirmed the criteria relied upon in *Finkl* for rider recovery of expenses, noting that the coal tar remediation expenses commonly incurred to comply with the mandate of

Citizens Utility Board holding demands consideration of the single-issue ratemaking argument.[4]

In the case of *City of Chicago v. Illinois Commerce Comm'n,* 281 Ill.App.3d 617 (1st Dist. 1996) ("*City II*"), the First District Appellate Court upheld the Commission's approval of a separate line-item charge for franchise fees to be charged to the residents of the municipalities assessing the fees and removing them from base rates. The Court cited the aforementioned *Citizens Utility Board* case, wherein the Court stated, "The rule (against single-issue ratemaking) does not circumscribe the Commission's ability to approve direct recovery of unique costs through a rider when circumstances warrant such treatment." *Citizens Utility Board,* 166 Ill.2d at 138. Those "circumstances", both the *City of Chicago* ruling and the *Citizens Utility Board* decision held, involved either the recovery of unexpected, volatile or fluctuating expenses, pursuant to *Finkl,* or direct recovery of a particular cost *without direct impact on the utility's rate of return. City of Chicago,* 281 Ill.App.3d at 628-629; *Citizens Utility Board,* 166 Ill. 2d at 1102-1103.

Accordingly, based on the case law issued to date, the Commission decisions implementing riders for the recovery of certain expenses have not been reversed by Illinois courts when the expenses at issue are (1) unexpected, volatile or fluctuating, pursuant to *Finkl* and the 1958 *City of Chicago* case, or (2) imposed on the utility by law, pursuant to the *Citizens Utility Board* and *City of Chicago* cases. Establishing a test year

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federal and state law are sufficiently volatile and not within management's control to justify rider recovery. The Court also noted that such expenses have historically been recoverable from ratepayers. *Citizens Utility Board, 166 Ill.2d* at 122-123.

[4] It should be noted, however, that the *Citizens Utility Board* decision did not reverse the *Finkl* court's holding that the Commission's approval of ComEd's Rider 22 violated that prohibition against single-issue ratemaking, despite the fact that the docket at issue in *Finkl* was not a general rate case. Accordingly, the Commission is obligated to examine all proposals to recover expenses (or lost revenues, as in this instance) via rider mechanisms through the single-issue ratemaking lense, whether or not the riders are proposed within the context of a general rate case.

revenue level is an essential element traditionally built into a utility's revenue requirement and base rates through the test-year ratemaking process. Accordingly, maintaining a set level of revenues per customer does not qualify as the kind of "expenses" that might be recovered under any existing court decision.

Further, none of the cases in which rider recovery was permitted involved recovery of lost revenues, and none involved a base ratemaking proceeding, as is the instant case. A revenue requirement that includes a test year level of revenues, along with all other revenue requirement components, will be established in this case. Rider VBA would single-out a proposed level of "revenues per customer" – *without examining all other variable revenue requirement elements* – and adjust customer rates on a monthly basis based solely on this artificial benchmark.[5] That phenomenon constitutes classic single-issue ratemaking.

2. Rider VBA Violates the Prohibition Against Retroactive Ratemaking.

The *Finkl* decision also concluded that the rider in question, which like Rider VBA, adjusted rates for lost revenues associated with energy efficiency, violated the rule against retroactive ratemaking. *Finkl,* 250 Ill.App.3d at 329. Rider VBA violates the prohibition against retroactive ratemaking by permitting monthly and annual rate adjustments after rates are established in this case that are not contemplated by the Public Utilities Act. Rider VBA would adjust future residential non-heating, heating and

[5] As noted in the AG Initial Brief, Rider VBA's measure of "revenues per customer" as a benchmark for adjusting customer rates monthly is a made-up rubric. First, when the Commission sets rates, it does so by making a best estimate of the normalized, average number of heating degree days for purposes of predicting revenues. Other trends, such as the number of customer bills the Company can expect to send out on a going forward basis, are also examined and utilized as billing determinants.[5] As such, the Commission's ratemaking process accounts for what appears to be "normal" conditions that by virtue of the computational averaging involved account for the variability in gas usage attributable to several causes, including conservation, efficiency, and variable weather.

general service (Rate 2) customer bills on a monthly basis, using comparisons of actual vs. prior rate case data applying formulistic rate changes determined under the rider. For example, the Rider VBA amount to be computed based on October results would be applied to customer bills in December. PGL Ex. VG-1.0 at 47; NS Ex. VG-1.0 at 42.

In addition to monthly adjustment of rates based upon usage per customer, Rider VBA's tariff provisions require annual true-ups, with any resulting adjustment (positive or negative) added to or deducted from customers' bills during that period. PGL/NS witness Valerie Grace testified that "(a)ny difference between actual billed revenues arising from distribution charges plus the adjustment and approved distribution margin under the rider will be reconciled on an annual basis and amortized over a 10-month period beginning March, with any resulting positive or negative adjustment added to customers' bills during that period." PGL Ex. VG-1.0 at 47; NS Ex. VG-1.0 at 43.

While reconciliations are permissible and do not constitute illegal retroactive ratemaking for expenses appropriately recovered under a rider, such as Purchased Gas Adjustment Clause proceedings or environmental remediation dockets, reconciliations on both a monthly and annual basis to capture revenue changes are not permitted under the Act or any Illinois case law analyzing rider recovery. Rider VBA is illegal for this reason as well.

3. Rider VBA Violates the Commission's Test Year Rules.

Not surprisingly, the Companies further assert that Rider VBA does not violate the Commission's test year rules. In support of this position, the Companies offer this tautology:

> There are no test year prescriptions that are violated by Rider VBA because this case arises out of a general rate case proceeding where the costs and expenses

> have been submitted under the Commission's test year rules. Hence the base rates that are approved in this case and which are the basis for the margin revenues to be recovered under Rider VBA have been evaluated in accordance with the appropriate test year prescriptions.

PGL/NS BOE at 52. This crude analysis omits a critical fact: Rider VBA adjusts customer rates on a monthly basis to reflect changes in *one* element of the test year revenue requirement calculation without examining other (offsetting) expense and revenue components. This is precisely the kind of mismatch that triggers a test year rule violation. As noted by the Illinois Supreme Court in *Business & Professional People for the Public Interest v. Illinois Commerce Commission*, 146 Ill.2d 175, 238, 585 N.E.2d 1032 (*BPI II)* (1991), the purpose of the test year rule is to prevent a "mismatching" of potentially offsetting elements of the revenue requirement formula. *BPI II,* 146 Ill. 2d at 238, *citing BPI I,* 146 Ill. 2d at 238, 242.

The terms and conditions laid out in Rider VBA are inconsistent with the test year rule upheld by Illinois courts. Rider VBA would adjust Rate 1 and 2 customer rates on a monthly basis using actual and rate case data from the second month prior to the effective month of the adjustment determined under the rider. No legitimate rationale that would justify this kind of rider treatment was presented by the Companies so as to constitute the kind of "unique costs" that Illinois courts have ruled justify rider recovery. This clear violation of the test year ratemaking precept is yet another reason to reject the Companies' Rider VBA and WNA proposals.

C. The Companies' Suggestion That The Proposed Order Approved An Alleged "Preferable Technique" Test For Rider Recovery Misstates The ALJs' Analysis In The Rider ICR Section of the Proposed Order.

In an attempt to further obfuscate the applicable case law regarding implementation of riders, as well as the analysis in the Rider ICR section of the Proposed Order, the Companies imply that the ALJs articulate a "preferable technique" principle as a criterion for rider treatment. PGL/NS BOE at 47. Again, citing the *City I* holding, and later referencing the reasoning in the Rider ICR section of the ALJPO, the Companies opine that "(t)he Court's holding certainly did not limit the Commission's exercise of discretion to employ riders to those instances where the particular matters for recovery have previously been the subject of a specific rate recovery method or approach." PGL/NS BOE at 47.

A re-reading of the ALJs' analysis in the Rider ICR section of the PO, however, quickly reveals the distortion in the Companies' argument. In reviewing the *City I* decision, the ALJs simply noted – and they used the word "note" – "that there is no existing practice of incorporating the depreciation and carrying costs associated with capital investments into base rates without a rate review proceeding." ALJPO at 145. Like the Companies attempt to note similarities between the *City I* case and the proposed Rider VBA, the ALJs simply observed a difference in the fact patterns between that case and the instant docket, as would any legitimate legal analysis. In no way did the Proposed Order assert that this was a criterion or prerequisite for rider treatment, as the Companies suggest. Accordingly, this distortion of the ALJs reasoning in the Rider ICR section of the Proposed Order should be rejected.

D. The Companies' Claim That The Question of Rider Recovery Should Center On Whether A Cost is Inevitable Should Be Rejected.

Without reference to a single case citation, the Companies offer in their Brief on Exceptions a new legal standard for the Commission's review of Rider VBA, arguing that the analysis should appropriately center on whether a cost is "inevitable". PGL/NS BOE at 52. This peculiar, eleventh-hour proposal misstates decades of Illinois court rulings on permissible rider recovery.

There is a reason no case law is sighted to support such a standard. That is because no such rulings or discussion of the "inevitability" of an expense exists. Accordingly, this specious argument should be soundly rejected.

E. Notwithstanding Its Illegality, Rider VBA Should Not Be Implemented On A Trial Basis.

Notwithstanding the legal infirmities of Rider VBA, the Companies urge the Commission to adopt their Rider VBA proposal on a trial or conditioned basis if the Commission has any reservations about the long-term impact of decoupling. PGL/NS BOE at 50. This request should be rejected for several reasons.

1. Commission Decisions Must Be Based On Record Evidence, Not Any Desire To Test A New Ratemaking Methodology.

First, implementing an unorthodox ratemaking mechanism such as Rider VBA on the basis of some generic desire to observe the rate effects of decoupling hardly constitutes reasoned, regulatory policy development. Section 10-103 of the Public Utilities Act requires that "any finding, disposition or order made by the Commission shall be based exclusively on the record for decision in the case, which shall include only the transcript of testimony and exhibits together with all papers and requests filed in the proceeding, including, in contested cases, the documents and information described in Section 10-35 of the Illinois Administrative Procedure Act."[6] Accordingly, this

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[6] Section 10-35 of the APA provides as follows:
Record in contested cases.
(a) The record in a contested case shall include the following:

Commission must make a decision in this case based on the record and Illinois law, and *not*, as the Companies hope, based on some alleged trend in the natural gas industry.

Implementing decoupling on some sort of trial basis does not excuse the Companies from meeting their statutory burden of proof. As detailed below and in the AG and Staff briefs filed in this docket, the record is clear that there is no financial need for Rider VBA.

2. The Companies' Continued Reference To "The Business Challenges" Rider VBA Purportedly Addresses Are Problems That The Companies Failed To Prove Existed, Let Alone Were In Need Of An Extraordinary Ratemaking Fix.

Sprinkled throughout the Companies briefs in this case, including their Brief on Exceptions, are constant references to substantial "business challenges" in need of extraordinary ratemaking relief. For example, at page 49 of their Brief on Exceptions, the Companies reference "business conditions of fluctuating customer usage and the inability to recover authorized margin revenues." PGL/NS BOE at 49.

As thoroughly discussed in the AG Initial Brief, at pages 53-67, as well as the AG Brief on Exceptions, at pages 12-23, the record evidence in the case shows that maintaining a designated level of revenues per customer, which is what Rider VBA

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(1) All pleadings (including all notices and responses thereto), motions, and rulings.
(2) All evidence received.
(3) A statement of matters officially noticed.
(4) Any offers of proof, objections, and rulings thereon.
(5) Any proposed findings and exceptions.
(6) Any decision, opinion, or report by the administrative law judge.
(7) All staff memoranda or data submitted to the administrative law judge or members of the agency in connection with their consideration of the case that are inconsistent with Section 10-60.
(8) Any communication prohibited by Section 10-60. No such communication shall form the basis for any finding of fact.
(b) Oral proceedings or any part thereof shall be recorded stenographically or by other means that will adequately insure the preservation of the testimony or oral proceedings and shall be transcribed on the request of any party.
(c) Findings of fact shall be based exclusively on the evidence and on matters officially noticed.
5 ILCS 100/10-35.

accomplishes, is neither needed nor appropriate. For example, the Companies' Rider VBA proposal presumes that even after new rates are set, the ability to recover its "margin revenues" is put at risk because (1) some of the Company's cost of service is recovered through the volumetric charges, thus making revenue recovery dependent on customer usage of natural gas, and (2) rates for the utility are based on historical or embedded costs and rates for new customers are going to have to be higher to reflect the changes in costs." PGL Ex. RAF-1.0 at 15; PGL Ex. RAF-2.0 at 11; Tr. 1313. Under Mr. Feingold's critique of ratemaking, traditional rate of return ratemaking can *never* successfully recover the Company's cost of service as long as volumetric charges are a part of delivery service ratemaking and as long as the passage of time occurs after rates are set. For example, Mr. Feingold stated that any time customers reduce their consumption due to either warmer-than-normal weather or conservation, that reduction in usage was not anticipated in the ratemaking process, and accordingly the Companies cannot fully recover their cost of service. Tr. 1397-1398. Mr. Feingold views traditional ratemaking, and its ability to recover the utility's cost of service after a new revenue requirement has been set, as a hopeless enterprise.

This flawed view of traditional ratemaking which is at the heart of the Companies' Rider VBA proposal, ignores several critical facts. First, when the Commission sets rates, it does so by making a best estimate of the normalized, average number of heating degree days for purposes of predicting revenues. Other trends, such as the number of customer bills the Company can expect to send out on a going forward basis, are also examined and utilized as billing determinants.[7] As such, the Commission's ratemaking process accounts for what appears to be "normal" conditions

[7] *See,* e.g., PGL Schedule E-5, Section B, page 1, Section E, page 1.

that by virtue of the computational averaging involved account for both highs and lows in weather conditions.

Second, Mr. Feingold's point about inflation over time affecting the cost of service ignores the fact that Peoples' operations and maintenance ("O&M") expense has actually decreased in a couple of important categories, such as depreciation and labor costs. PGL Ex. LTB-1.0 at 12-13; AG Cross Ex. (Borgard) 1. In fact, Mr. Feingold admitted that in making his assertions about the effect of inflation over time and its impact upon the cost of connecting new customers, he did not look at any specifics as to the number and kind of new customers, or what kinds of equipment needs they might possess. Tr. 1312. The Companies' position makes no room for the possibility that improvement in productivity that can serve to reduce otherwise fixed costs of utility operations or that increases in overall revenues through customer growth can occur to offset reduced revenues associated with declines in usage per customer. Mr. Feingold's premise as to why Riders VBA or WNA are needed, accordingly, are based on theories that are abstract in nature and not sufficiently tied to the facts and cost of service characteristics particular to these two companies.

Other assumptions in Mr. Feingold's unorthodox ratemaking vision, upon which the Companies' rider proposals are founded, are likewise unpersuasive. Under Mr. Feingold's ratemaking paradigm, for example, a natural gas delivery utility should be made whole for all load losses, no matter whether the decline in usage is due to conservation efforts, customers' desire to dial down the thermostat and reduce winter heating bills in response to high gas prices, or the prevalence and installation of more efficient appliances. Further, under Rider VBA, the traditional notion of cost causation and revenue recovery is turned on its head. The amount of natural gas service used by a customer becomes irrelevant to the amount of money owed to the utility for gas delivery service. When usage per customer declines, the Companies assert, Peoples' and North Shore's revenues and profits decline and its cost of service is not fully recovered. Indeed, even when revenues collected from new customers offset the impact of reduced usage by existing customers so that there is no loss in overall revenues, a surcharge is nonetheless imposed on Rate 1 and Rate 2 customer bills under the Companies' Rider VBA proposal. PGL Ex. VG-1.0 at 46, 47. NS Ex. VG-1.0 at 42.

The Companies' proposed ratemaking remedy thus is premised on the incorrect notion that a "normalized gas use per customer" (PGL Ex. RAF-1.0 at 9; NS Ex. RAF-1.0 at 8) is explicitly established and becomes an entitlement for the utility when the Commission sets rates in a rate case. However, state and federal regulatory law is not premised on the concept of maintaining a utility's "margin revenues". As discussed in the AG's Brief at pages 41-45, seminal federal cases in utility regulation make clear that a utility is entitled to the *opportunity* to earn a reasonable return of and on its prudently incurred utility plant. For example, as discussed at pages 32-35 of the AG Initial Brief, in the landmark case *Bluefield Waterworks Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 279 (1923), the U.S. Supreme Court established that a utility's rates should reflect the opportunity – not a guarantee – to earn a return on its used and useful property when a commission sets rates. No mention is made of an inherent right to maintain some level of "margin revenues" or "use per customer".

Moreover, Rider VBA's premise that a normalized usage level per customer must be maintained through monthly rate adjustments contradicts the reality that ratemaking input values change as time passes, including test year expenses, the cost of capital and test year rate base components. None of these variables are expected to remain constant after completing a rate case, and these changes, some favorable and some unfavorable, will impact earnings after the test year. GCI Ex. MLB-1.0 at 36. Neither the Public Utilities Act nor Illinois utility ratemaking case law asserts a utility right to maintain a specified level of revenues or usage per customer.

Conspicuously absent from the record is any evidence that *overall* margin revenues have dropped precipitously or become unstable in the years since the Companies' last rate case so as to justify the unorthodox ratemaking treatment that Rider VBA brings. Notwithstanding the declines in usage *per customer* detailed by Messrs. Borgard and Feingold, the record evidence shows that Peoples Gas earned around or significantly above its authorized return on common equity in eight of the last 12 years, as noted earlier in this Brief. AG Cross (Borgard) Ex. 3.

Most important, these exceptional earnings occurred while actual use per customer – the benchmark that the Companies consistently cite – was persistently below the normalized use per customer set in the prior rate case. *See* PGL Ex. LTB-1.2, NS Ex. LTB- 1.2, AG Cross (Borgard) Ex. 3. Additionally, PGL/NS witness Feingold confirmed that these exceptional earnings occurred despite reported declines in margin revenues in these years. Tr. 1307-1308. As noted above, in fact, overall margin revenues for both companies have been remarkably stable. The Companies simply have provided no basis for the extraordinary ratemaking treatment inherent in Rider VBA.

Company COO Borgard affirmed that the quest for improved productivity that contributed to the Companies going some 12 years without filing a rate case will continue, stating that they are constantly in the process of identifying and implementing technological innovations and investigating and implementing best practices. Tr. 370. In addition, Mr. Borgard testified that management will continue to seek out efficiencies and cost reduction opportunities after this rate case is completed. Tr. 370. When the Commission issues its order in this case, a revised revenue requirement will be established and new rates set to reflect the Company's cost of service and required return on investment. Company COO Borgard admitted that if the Companies' efforts toward creating O&M efficiencies continue into the near future, Rider VBA provides no offset for the reduction in revenue requirement associated with such O&M savings. Tr. 381-383. The Companies' Rider VBA proposal is one-sided in this regard, as is its failure to account for revenue growth associated with new customers, and could arguably result in a windfall for the Companies, given the piecemeal revenue increases to flow from the Companies' continued expectation of declining usage per customer. Indeed, Mr. Borgard confirmed that the Companies *can* continue to provide safe, adequate and reliable service to all customers *without Rider VBA.* Tr. 392.

Finally, it is important to note that PGL/NS CEO Borgard and PGL/NS witness Feingold confirmed during cross-examination that the alleged problem that Rider VBA focuses on – declining natural gas usage per customer – has been occurring for decades. Tr. 378; 1321-1322. Mr. Feingold, in fact, acknowledged the phenomenon has been occurring since at least 1980. Tr. 1321-1322. The companies have not been in for a rate increase since 1995. It is only in the last few years that the companies' have not consistently met their authorized return. Presumably, that is why Peoples filed this rate case. Clearly, traditional rate of return regulation has served the companies and its customers well. The Companies have presented no evidence that such a winning scenario under traditional test year regulation cannot be sustained without Riders VBA or WNA.

The evidence shows that Rider VBA simply is not needed for the Companies to continue to provide safe, reliable, least-cost service to its customers and a reasonable return to its shareholders. If implemented – on a trial basis or otherwise – Rider VBA will significantly increase the amount ratepayers pay for using, and ironically not using, natural gas service. That important fact should not get lost in the discussion.

As uncovered in GCI witness Brosch's testimony and Staff witness Peter Lazare's testimony, incremental Rider VBA revenues would have provided an additional $218 million to Peoples Gas pretax operating income over the past five years and an additional $24 million to North Shore, had Rider VBA been in place. GCI Ex. MLB-1.0 at 37; GCI Ex. MLB-1.3; Staff Ex. 8.0 at 7. This information is attached to the AG Initial Brief as Appendix D. This attachment shows that ratepayers would have paid much higher rates if the Companies' proposed decoupling mechanism had been in place, with margin revenues increasing in 2006 by about 11.2 percent for PGL and 8.9 percent for North Shore. *Id.*

Accordingly, the Companies' continual reference to their "business challenges" and their need to ensure margin revenue recovery should be rejected.

F. The Companies' Implication That Rider VBA Is Needed To Offset The Effects of its Proposed Energy Efficiency Program Has No Evidentiary Support In The Record.

At page 51 of their BOE, PGL and North Shore complain that rejecting Rider VBA "while awarding the beneficial effects of the implementation of energy efficiency programs …will worsen the Utilities' business challenges by further diminishing the

Utilities' ability to recover margin revenues." PGL/NS BOE at 51. The Companies further claim that "to defer or eliminate consideration of the impacts of these benefits on the Utilities is arbitrary and an abuse of discretion." *Id.*

This hollow claim should be dismissed for the rhetoric that it is. There is not a shred of evidence in the record that the proposed $7.5 million energy efficiency program ("EEP") being proposed in this docket will impact the opportunity or ability of the Companies to recover their revenue requirement. Peoples Gas and North Shore have no idea what programs will be offered through the program because they have yet to be designed. Given the third-party governance board structure being proposed and endorsed by the parties, the Companies can only speculate regarding the program's effect on customer usage.

Further, it should be noted that the proposed EEP is an extremely modest one in terms of funding and scope. PGL/NS COO Borgard testified that the Companies will not be spending a dollar more than the $7.5 million proposed -- *with or without Rider VBA.* . Tr. 389, 390. The PGL/NS program pales in comparison in terms of funding amount when compared to other programs approved in nearby Midwestern states. *See* ELPC Ex. 2.0 (Kubert Rebuttal) at lines 177-182. The assertion that the Companies' margin revenues will be significantly impacted by the proposed EEP simply is not credible.

Moreover, ratepayers – not the Companies or its shareholders – are funding the EEP. Accordingly, ratepayers are entitled to any of the modest benefits that may arise out of the program without being penalized through monthly surcharges for gas they do not use.

As noted in the AG Brief on Exceptions, Peoples Gas and North Shore, never established any link between the $7.5 million energy efficiency program offered by the Companies and the need for decoupling. AG BOE at 18-21. Moreover, the discussion of decoupling within the context of energy efficiency ignores the fact that the Companies' specific Rider VBA proposal would have adjusted customer rates for usage per customer declines that are triggered by a variety of factors, not necessarily energy efficiency.

Again, Rider VBA would recognize, and adjust rates for, usage declines associated with warmer weather, customer replacement of old and less efficient appliances, improved building code efficiencies as well as customers dialing down thermostats in response to higher natural gas commodity prices. GCI Ex. 1.0 at 42, 43. Rider VBA, accordingly, is overly broad in its application of rate adjustments purportedly related to energy efficiency.

Finally, as noted by GCI witness Michael Brosch, neither PGL/North Shore witnesses Feingold nor Borgard addressed the question of how implementation of Rider VBA will affect *customer* incentives to conserve energy and utilize energy efficiency measures on their own. Notably, Rider VBA, in effect, punishes Peoples and North Shore customers by raising future per therm charges on a monthly basis when customers conserve and reduce future gas usage and margin revenue-per-customer below the threshold level set in this docket. In addition to causing customer confusion given the contradictory price signals sent by adjusting per therm charges upward when usage per customer decreases, Rider VBA will likely diminish the incentive customers have to lower their thermostats, invest in more energy efficient appliances and weatherization measures, or even participate in the company-sponsored programs. GCI Ex. 1.0 at 44.

So, again, the notion that Rider VBA is needed, either to offset or promote energy efficiency participation, is hollow rhetoric.

For all of these reasons, the Commission should reject the Companies arguments in support of Rider VBA.

G. The Rider VBA Proposal Is *Not* a "New Rate Design Approach"; It Is Nothing Less Than A Request to Radically Revamp How Ratepayers Pay For Utility Service.

In their argument against the Proposed Order's implicit observation that no legal authority exists for approval of Rider VBA, the Companies proffer what is perhaps one of their most outrageous statements: that Rider VBA "is merely a policy decision to employ a new rate design approach, as occurred in *City 1*." PGL/NS BOE at 53.

Peoples Gas' and North Shore's proposals to increase the residential heating customer charges by more than 111% and 88%, respectively, are rate design proposals. Asking for a ratemaking tool that assesses residential and small business customers an additional charge each month for natural gas they *do not use* in order to *guarantee* a utility a designated revenue level is nothing less than a radical departure from traditional rate of return regulation.

In the landmark case *Bluefield Waterworks Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 279 (1923), the U.S. Supreme Court established that a utility's rates should reflect the opportunity – not a guarantee – to earn a return on its used and useful property when a commission sets rates. The Supreme Court elaborated on the principles governing rate of return regulation in the case of *Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 591, (1941). Here, the Supreme Court reaffirmed its holding in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S.575, 590 (1942) that "regulation does not insure that the business shall produce net revenues." *Hope Natural Gas*, 320 U.S. at 603.

Illinois courts have adopted the *Hope* and *Bluefield* standards and applied them to the regulation of utilities in Illinois: " 'The rate making process under the act, i.e., the fixing of 'just and reasonable' rates[,] involves a balancing of the investor and the consumer interests.' " *Illinois Bell Telephone Co. v. Illinois Commerce Comm'n (1953)*, 414 Ill. 275, 287, 111 N.E.2d 329, quoting *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603, (1944). Similarly, the Illinois Supreme court earlier established that a just and reasonable rate must be less than the value of the service to consumers. *State Public Utilities Comm'n ex rel. City of Springfield v. Springfield Gas & Electric Co.*, 291 Ill. 209, 216, 125 N.E. 891 (1919). The appellate court elaborated on this pronouncement in *Camelot Utilities, Inc. v. Illinois Commerce Comm'n*, 51 Ill.App.3d 5, 10, 365 N.E.2d 312 (1977), wherein the Court declared that it is the ratepayers' interest which must come first:

> "The Commission has the responsibility of balancing the right of the utility's investors to a fair rate of return against the right of the public that it pay no more than the reasonable value of the utility's services. While the rates allowed can never be so low as to be confiscatory, within this outer boundary, if the rightful expectations of the investor are not compatible with those of the consuming public, it is the latter which must prevail."

Camelot Utilities, 51 Ill.App.3d at 10; *Citizens Utility Board v. Illinois Commerce Comm'n*, 276 Ill.App.3d 730, 658 N.E.2d 1194 (1995).

All of these landmark holdings, as well as Illinois courts' interpretations of the decisions, suggest that the Company's request for the guaranteed recovery of the "margin revenue" stream established when rates are set in this case, as well as a specific revenue stream from the residential and commercial classes (Rates 1 and 2) through Rider VBA, has no support in the utility regulatory law that has guided this Commission's establishment of rates. Approval of the Company's Rider VBA – and thereby adoption of the Companies' mantra that margin revenues must be guaranteed – would be tantamount to rejection of the well-established utility ratemaking principles that prescribe what is and is not assured to monopoly utilities under the existing regulatory framework.

The Commission's Order issued in this docket will recalibrate rates for Peoples Gas and North Shore based on the revenue requirement designated by the record evidence and the Commission's findings. In terms of a duty to ensure the utilities the opportunity to recover in rates the cost of providing utility service and a fair return on rate base, the Commission's authority and responsibility ends there. There simply is no basis in state and federal regulatory law to support the Companies' belief that they are entitled to a guaranteed revenue stream that matches a level established in a rate case. The suggestion, then, that Rider VBA is just another rate design proposal is empty rhetoric.

For all of the reasons discussed above, in the AG's Brief on Exceptions and Initial and Reply Briefs, Riders VBA and WNA, discussed later in this Brief, should be rejected by the Commission.

VI. RIDER WNA

Rider WNA is nothing more than the Companies' Rider VBA "Plan B". The Companies ask the Commission to approve it for the same reasons the Companies request approval of Rider VBA: the Companies seek a guaranteed revenue stream. While the Rider WNA monthly surcharge would narrow the bases for bill adjustments to revenue variations caused by weather, this rider mechanism would "ensure that the level of sales volumes established to recover their fixed costs is always reflected in the monthly billings to customers." NS/PGL Ex. RAF-2.0 at 61. As noted above in the Rider VBA section, this request is neither legal nor warranted by the record evidence.

A. Rider WNA Should Be Rejected For the Same Reasons Rider VBA Should Be Rejected: Guaranteeing the Utilities An Approved Margin Revenue Stream Is Neither Permitted Under the Act Nor Needed Based On Record Evidence.

In their Rider WNA section of their Brief on Exceptions, Peoples Gas and North Shore recycle the identical arguments offered in support of Rider VBA: the Companies claim that they have not been able to recover "approved margin revenue levels". PGL/NS at 54. The same theoretical and legal flaws in the Companies' rationale for Rider VBA discussed earlier in this Brief – that extraordinary ratemaking treatment is necessary to "ensure" margin revenue recovery – exist with the Rider WNA proposal. In fact, the record evidence shows there simply is no basis in fact or law to justify monthly adjustments to rates based on changes to the weather in an effort to guarantee a set revenue stream.

As noted in the AG Brief on Exceptions, both Staff witness Lazare and GCI witness Brosch testified that neither Company demonstrated a need for Rider WNA. Mr. Brosch found no showing of significant margin revenue volatility that is required to demonstrate any earnings stabilization need for Rider WNA. GCI Ex. MLB-4.0 at 29. Moreover, as noted in the Rider VBA discussion above, the Companies' historical margin revenues have been remarkably stable, as shown at Tables 6 and 7 in Mr. Brosch's rebuttal testimony. *Id.* at 6, 7. The Companies' corresponding levels of achieved return on equity have also been relatively stable in a range between 10 and 15 percent in most years, as shown in Table 1 at page 19 of Mr. Brosch's direct testimony. GCI Ex. MLG-1.0 at 19.

Staff witness Lazare likewise concluded that Rider WNA should be rejected. He testified that Rider WNA will serve as a revenue enhancing tool. ICC Ex. 20.0 at 31. He noted that the Companies presented testimony that a general warming trend justifies switching from a 30-year heating degree day average to a 10-year average. *Id.* Given this testimony, the Companies cannot dispute that they expect Rider WNA to trigger surcharges rather than downward rate adjustments. Accordingly, the record evidence demonstrates that the Companies failed to provide a credible, financial justification for the approval of Rider WNA.

Moreover, the traditional ratemaking process already incorporates a normalization of weather variations in its calculation of heating degree days and the resulting calculation of test year revenues. The test year process is designed to reflect a normalized level of revenues and expenses that is then built into customer rates. Rider WNA takes this normalization process a step further in an effort to guarantee a certain level of margin revenue recovery that is neither needed or legal.

In addition, record evidence revealed that the Companies already have a mechanism in place to help ensure weather-related revenues: weather insurance policies. CUB/City Ex. 1.0 at 65; CUB/City Ex. 1.04; Tr. 1599. PGL/NS witness James Schott confirmed that the purpose of this policy was to "help make up the difference" in the form of a payout to the parent company if the Companies were unable to achieve their returns on equity due to weather variables. Tr. 1598-1599. Payouts to the parent company occurred based on the number of heating degree days achieved in a given time period. Tr. 1601-1602. The availability of such a mechanism, coupled with the normalization of weather that occurs in the calculation of test year revenues under traditional regulation, helps protect the Companies from warmer-than-normal weather.

The Companies simply failed to prove that Rider WNA is needed, and a specific conclusion in this regard should be included in the Proposed Order.

B. Rider WNA Suffers From the Same Legal Infirmities as Rider VBA.

The Companies opine that Rider WNA "would not constitute retroactive or single issue ratemaking." PGL/NS BOE at 55. They further note "a rider which addresses margin revenues has not been found unlawful in Illinois." *Id.* Like the arguments presented in support of Rider VBA, the Companies reference Rider WNA's "mathematical formula", cite the *City I* case and proclaim that approval of the rider is "within the Commission's broad discretion to adopt riders and make pragmatic rate adjustments."

For the reasons stated above in the Rider VBA portion of this Brief, the Companies' arguments in this regard should be rejected. As noted in the Rider VBA section above, the Companies reliance on *City I* is misplaced and ignores nearly 50 years of subsequent Illinois case law addressing these ratemaking issues. Moreover, Rider WNA would trigger monthly rate adjustments, up or down, between rate cases based upon weather variations from a base case scenario established in this docket for rate classes 1 (Residential) Non-heating, Heating and 2 (General Service) *after operating revenues are established in this rate case*. NS/PGL Ex. VG-2.0 at 56. Rider WNA's singular focus on ameliorating any reductions in revenues associated with warmer than normal weather through monthly rate adjustments between rate cases, like Rider VBA, violates the Act's prohibition against single-issue and retroactive ratemaking. *See* AG Initial Brief at 35, 47-48, 73; AG Reply Brief at 48, 49. Staff likewise concurred in its Brief that Rider WNA violated the single-issue and retroactive ratemaking principles. Staff Brief at 185.

The Companies assert in their BOE that the "symmetrical operation of Rider WNA", which adjusts rates up or down on a monthly basis based on the weather, "ensures that the Utilities and their customers are afforded equal treatment in the operation of the rate adjustment." PGL/NS BOE at 56. They assert that Rider WNA "does not involve the impact of any set of costs and expenses on the revenue requirement or rate of return", and, accordingly, does not constitute single-issue ratemaking.

This analysis is simplistic, erroneous and a distortion of the prohibition against single-issue ratemaking. Rider WNA dissects the Commission's calculation of a test year revenue level for purposes of setting rates and sets revenue recovery on autopilot.[8] Customer rates would be adjusted each month based on variations from Rider WNA's specific weather normalization calculation without examining other components of the revenue requirement, such as labor costs or revenue growth due to an increase in the number of customers, for example. *Regardless of whether Rider WNA triggers upward or downward adjustments,* such tinkering with the rates paid by customers constitutes classic single-issue ratemaking.

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[8] Rider WNA would adjust usage charges for rates 1 Non-heating, 2 Heating and 2 General Service during the winter heating season based on weather variations above or below the "normal" established in this case. The proposed Rider WNA is set forth as Exhibit VG 2.11 attached to Ms. Grace's rebuttal testimony, and provides for the monthly adjustment of customers bills for variations in "Actual Billing Cycle Heating Degree Days" from "Normal Billing Cycle Heating Degree Days" defined as based upon a 10-year normal temperature for O'Hare Airport, if approved by the Commission in this docket. GCI Ex. MLB-4.0 at 28. Section B of the proposed Rider WNA sets forth a formula for calculation of the adjustment value for each eligible rate class, using a heat factor coefficient that relates gas usage to temperature change. *Id.*

The rule against single-issue ratemaking is a ratemaking principle which recognizes that the revenue requirement formula is designed to determine a utility's revenue requirement based on the utility's *aggregate* costs and demand. *Citizens Utility Board v. Illinois Commerce Comm'n,* 166 Ill.2d 111, 136-137, 651 N.E.2d 1089 (1995); *Business and Professional People for the Public Interest v. Illinois Commerce Comm'n,* 146 Ill. 2d. 175, 244, 585 N.E.2d 1032 (1991) ("*BPI II").* The rule prohibits the Commission from considering changes to components of the revenue requirement in isolation. Consideration of one item in the revenue formula in isolation risks understatement or overstatement of the revenue requirement. *Id.* In presenting their rider proposals, the Companies have ignored the prohibition against single-issue ratemaking.

Also, Like Rider VBA, the proposed Rider WNA violates the Commission's and Illinois law's test-year principles by selecting only one component of the revenue requirement -- in this case a portion of overall revenues affected by weather variations not matching the "normal" weather assumptions established in this case -- tracking changes in that revenue requirement component, and then assessing rate adjustments to recognize this change. This singular focus on a single component of the revenue requirement violates the Commission's test year rules. Rider WNA should be rejected for these reasons as well.

Accordingly, the Companies arguments in support of Rider WNA should be rejected.

C. The Companies' Argument That Some Commissions Have Approved Weather Normalization Riders Is Irrelevant To This Proceeding.

At page 55 of their BOE, the Companies assert that "weather normalization adjustments are quite common and have been widely implemented across the country." PGL/NS BOE at 55. They suggest that approval of Rider WNA "could be an interim step pending more evaluation and consideration of decoupling." *Id.*

This observation is akin to informing the Commission that because rate increases have been approved in some jurisdictions recently for certain unnamed utilities, the Commission should grant its specific rate increase request. It is simply irrelevant to the facts in this docket, and ignores the requirement in the Public Utilities Act that the Commission base its decisions on the record and Illinois law.

An "interim step" of any kind is only appropriate if the record evidence support the change. As detailed above, that is not the case here. In sum, the Commission Analysis and Conclusion portion of the Rider WNA discussion should acknowledge the Company's failure to present a credible financial justification for enacting this extraordinary, alternative ratemaking mechanism. In addition, the PO should include specific language concluding that Rider WNA violates the prohibitions in the Act against single-issue and retroactive ratemaking, as well as the Commission's test year rules. Proposed language reflecting these conclusions is included in Attachment A to this Brief.

VII. RIDER ICR

In the Rider ICR section of their Brief on Exceptions, the Companies again repeat the same flawed legal rationale that forms the basis of the Rider VBA and WNA exceptions. The Companies assert that the 1958 *City I* decision held that the Commission has broad authority to approve riders. PGL/NS BOE at 57. The Companies opine that neither *City I* nor any subsequent case involving riders placed any restrictions on a rider that recovers depreciation and carrying costs, like the proposed Rider ICR. *Id.* at 58.

As noted in the Rider VBA portion of this Brief, the Companies conclusion on this point is simplistic and flawed. The recovery of depreciation and carrying costs associated with accelerated investment in four plant accounts is in no way comparable to the recovery of wholesale purchased gas costs incurred by the Companies, which prior to the *City I* ruling were always passed through to natural gas delivery customers without suspension. Both the *City I* case and subsequent Illinois court rulings do not support the view that Rider ICR passes legal muster.

A. Rider ICR Costs Are Not Comparable to Purchased Gas Costs.

The Company, in its BOE and in prior briefs cites three benefits associated with the Rider: (1) more expeditious replacement and modernization of PGL's distribution system, (2) financial benefits associated with expending current dollars; and (3) benefits afforded by the opportunity to respond to the dynamic development in the City of Chicago. PGL/NS BOE at 65-66. Conspicuously absent from these arguments is any assertion that Rider ICR (and the accelerated main replacement program) are needed for the provision of safe, reliable utility service. Moreover, as for the alleged financial difficulties that accompany waiting until a next rate case for the recovery of and on increased accelerated investment, PGL witness James Schott confirmed that no attempt to quantify the alleged financial detriment was ever made by Peoples officials. Tr. 1621. As such, it is imperative that the Commission understand that Rider ICR is *not* based on any professed need to replace CI/DI main because of safety or reliability issues or some inherent inability to recover costs associated with capital investment through traditional ratemaking. Unlike purchased gas costs, which are an integral part of the Companies' delivery service business, Rider ICR costs can be avoided at the Companies' discretion.

As noted in the Rider VBA section above, a review of the *City I* ruling, and subsequent Illinois case law interpreting the ratemaking rules of the Public Utilities Act quickly reveals that the Court in *City I* articulated no such unlimited authority as the Companies suggest. In that case, which approved the use of a rider for the recovery of purchased natural gas costs, the Court concluded that "the Public Utilities Act of Illinois vested in the commission the power to authorize an automatic adjustment clause to be filed in a rate schedule *in the proper case*." *City 1*, 13 Ill.2d at 614 (emphasis added). The Court carefully analyzed why the purchased gas rider constituted "the proper case". The Court specifically acknowledged, for example, the authority of the Federal Power Commission ("FPC") to oversee the rates charged to utilities for natural gas, and rejected the argument that the Commission has the authority to determine the reasonableness of the commodity rates, having concluded that the power to fix rates for natural gas transported and sold in interstate commerce was vested by congressional act to the exclusive jurisdiction of the FPC. *Id.* at 616. Indeed, the *City I* court noted that until the Commission approved the automatic adjustment clause for purchased gas costs, it was the practice of the Commission to allow rate increases based upon an anticipated increase in the cost of natural gas to go into effect without suspension. *Id.* at 618. It was within these factual constraints, then, that the Court held that the approved purchased gas adjustment rider "is simply an addition of a mathematical formula to the filed schedules of the Company under which the rates and charges fluctuate as the wholesale cost of gas to the Company fluctuates." *Id.* at 613.

No such analogy can be made with Rider ICR. Investing in discretionary main replacement projects and assessing customers a surcharge to recover the depreciation and carrying costs associated with that investment is in no way comparable to the wholesale purchased gas costs incurred by the Companies, which prior to the *City I* ruling were always passed through to natural gas delivery customers without suspension.

B. Rider ICR Costs Do Not Fit Any Of the Criteria For Permissible Rider Recovery Under Illinois Law.

As correctly noted in the ALJPO, Rider ICR costs in no way fit the criteria for rider recovery of *unexpected, volatile* or *fluctuating* expenses." *Finkl,* 250 Ill.App.3d at 327 (emphasis in original). As noted in the ALJPO:

> Main replacement is not itself unexpected. It has been ongoing since 1981 and will continue without Rider ICR until approximately 2050. There is no evidence that the principal costs involved in main replacement (such as labor, materials, permits or the cost of money) will rise abruptly or precipitously. There is only the familiar nostrum that costs incurred sooner are ultimately less than the same costs incurred later . What is unexpected - or, more accurately, unpredictable - according to PGL are future opportunities for cost-shaving and cost-sharing when other entities perform infrastructure work in Chicago. Such opportunities could arise more frequently than is customary, PGL contends, if, for example, the City's bid for the 2016 Summer Olympics is successful or the proposed Crosstown Expressway is constructed. However, if such extraordinary events are scheduled (and if the opportunities they present do implicate a substantial portion of PGL's unimproved main), PGL will know well in advance, with ample opportunity to request base rate adjustment. As for more mundane municipal projects and repairs, there is simply no evidence that the near future will differ from the recent past.

ALJPO at 147-148. Peoples opines that Rider ICR is needed because the ability to accelerate the replacement of infrastructure within the City of Chicago is unpredictable. PGL/NS BOE at 67. The uncontroverted evidence in the record, provided by the Companies own witnesses, shows this is not the case.

PGL's Vice President of Gas Operations Edward Doerk made clear during cross-examination that the Company currently work hand-in-hand with the City of Chicago to coordinate construction and public works projects to ensure efficient and timely main replacement. Mr. Doerk confirmed that there is a concerted effort under the Existing Main Replacement Program to coordinate Peoples' main replacement activities with the City of Chicago and other governmental entities' public work projects so that there is not unnecessary disturbance of recently completed infrastructure. Tr. 182. In fact, the Company regularly maintains "constant communication" with the City of Chicago regarding public works and construction projects taking place within the City. Tr. 183. Designated Peoples employees are assigned to regularly interface with the City. *Id.* Mr. Doerk confirmed, for example, that when the Company first heard of the City's plans for the Block 37 construction project (the city block bounded by Washington, Dearborn, Randolph and State streets), the Company looked at the existing main replacement schedule in that location to see if this would be an opportunity to replace cast iron mains with plastic. Tr. 185-186. Furthermore, during cross-examination, Mr. Schott admitted that, while he was "not sure of the specifics" regarding the coordination between the City and the Company, he confirmed that coordination between Peoples and the City regarding their respective construction plans is "standard operating procedure." Tr. 1653-1657. Accordingly, the Companies assertion that main replacement is an unpredictable enterprise is not credible, given the record evidence.

Based on the case law issued to date, as described in the Rider VBA section above, the Commission decisions implementing riders for the recovery of certain expenses have not been reversed by Illinois courts when the expenses at issue are (1) unexpected, volatile or fluctuating, pursuant to *Finkl* and the 1958 *City of Chicago* case, or (2) imposed on the utility by law, pursuant to the *Citizens Utility Board* and *City of Chicago* cases.

None of the cases in which rider recovery was permitted involved recovery of depreciation and capital costs, which is currently built into the traditional ratemaking process, and none involved a base ratemaking proceeding, as is the instant case. A revenue requirement that includes a test year level of plant additions and depreciation and deferred tax effects, along with all other revenue requirement components, will be established in this case. Rider ICR would single-out the recovery of depreciation and carrying charges associated with main replacement – *without examining all other variable revenue requirement elements* – and adjust customer rates on a monthly basis based solely on this artificial benchmark. That phenomenon constitutes classic single-issue ratemaking that the *Finkl, Citizens Utility Board and City of Chicago II* decisions acknowledged must not be triggered for permissible rider recovery.

C. Contrary to the Companies' Assertions, The Proposed Order Did Not Articulate a "Preferable Technique" Criterion For Rider Recovery.

As discussed in the Rider VBA section above, the Companies imply that the ALJs articulate a "preferable technique" principle as a criterion for rider treatment. PGL/NS BOE at 47. Again, citing the City I holding, the Companies repeat that "(t)he Court's holding certainly did not limit the Commission's exercise of discretion to employ riders to those instances where the particular matters for recovery have previously been the subject of a specific rate recovery method or approach." PGL/NS BOE at 59.

A re-reading of the ALJs' analysis in the Rider ICR section of the PO, however, quickly reveals the distortion in the Companies' argument. In reviewing the *City I* decision, the ALJs simply noted – and they used the word "note" – "that there is no existing practice of incorporating the depreciation and carrying costs associated with capital investments into base rates without a rate review proceeding." ALJPO at 145. As noted above in the Rider VBA section of this Brief, the ALJs simply observed a difference in the fact patterns between that case and the instant docket, as would any legitimate legal analysis. In no way did the Proposed Order assert that this was a criterion or prerequisite for rider treatment, as the Companies suggest. Accordingly, this distortion of the ALJs reasoning in the Rider ICR section of the Proposed Order should be rejected.

D. The Companies Again Misstate the *Finkl* Decision And Subsequent Illinois Case Law.

As correctly stated at page 145 of the PO, the common thread in decisions allowing rider treatment is that the rider recovery at issue in each case addressed a "burden" on a utility imposed by *costs* it cannot avoid or control. As noted in the *Finkl* case, "Riders are useful in alleviating the burden imposed upon a utility in meeting *unexpected, volatile* or *fluctuating* expenses." *Finkl*, 250 Ill.App.3d at 327 (emphasis in original). Given that Rider ICR would recover depreciation and carrying costs associated with cast iron main investment made at Peoples Gas' discretion disqualifies it as permissible under this standard. Peoples Gas' assertions that Rider ICR expenses do satisfy the *Finkl* criteria at pages 61 and 62 of its BOE should be rejected.

In their attempt to convince the Commission that Rider ICR is legal, the Companies offer simplistic interpretations of the Public Utilities Act's prohibition against single-issue ratemaking and the Commission's test year rules. For example, the Companies' assertion at pages 62 and 63 that any concern about single-issue ratemaking "can be ameliorated by conditioning approval of Rider ICR upon Peoples Gas including as an offset against Rider ICR charges amounts reasonably attributable to leak repair savings and reductions in deferred taxes occasioned by CI/DI main replacement." PGL/NS BOE at 63. Their additional assertion that the rate adjustments that would be triggered under Rider VBA "will never change the Utilities revenue requirement" obfuscates the rule against single-issue ratemaking. The Companies' interpretation of Illinois case law addressing rider recovery of utility expenses ignores the plain fact that Rider ICR will adjust customer rates on a monthly basis based on the Company's discretionary investment in cast iron main replacement, in violation of the prohibition against single-issue and retroactive ratemaking, as well as the Commission's rules.

As noted in the AG Brief on Exceptions, there is more to the prohibition against single-issue ratemaking than ensuring a rider reflects both savings and expenses in the rate adjustment mechanism. The rule against single-issue ratemaking also recognizes the inequity of adjusting rates based upon a single expense item without examining other entire expense and revenue categories. That legal requirement – ensuring that no mismatch of expense and revenue items occurs within the ratemaking process – likewise prohibits approval of Rider ICR.

For example, while the Company may incur increased capital costs associated with the ICR investment, it may be generating increased revenues through an expanded customer base or reducing its operating expenses as a result of decreased pension expense in a given year, for example. Rider ICR ignores these other possible changes in operating income while still increasing rates on a monthly basis for Rider ICR investments.

Further, the Company's analysis of Rider ICR omits any discussion of the concomitant violation of the Commission's test year rules. As correctly noted in the Proposed Order,

> "…the courts have consistently held that when a utility's actions may affect its overall revenue needs in disparate ways, all impacts of such actions – both expenses and savings – must be considered and balanced in ratemaking."

PO at 146. Similarly, the process used to evaluate and measure the cost of service and resulting revenue requirement is the rate case, in which a balanced review of jurisdictional expenses, rate base investment, the cost of capital and revenues at present rates can be undertaken at a common point in time, referred to as a test period or test year. GCI Ex. 1.0 at 5; see also *Business & Professional People for the Public Interest v. Illinois Commerce Commission,* 146 Ill.2d 175, 238, 585 N.E.2d 1032 (*BPI II)* (1991). As noted by the Illinois Supreme Court in *BPI II*, the purpose of the test year rule is to prevent a "mismatching" of potentially offsetting elements of the revenue requirement formula. *BPI I,* 146 Ill. 2d at 238, 242.

The terms and conditions laid out in Rider ICR are inconsistent with the test year rule upheld by Illinois courts. ICR would adjust rates based on a baseline historical average level of investment in four designated plant accounts for purposes of calculating the monthly surcharge, limiting qualifying plant for cost recovery to investments that are non-revenue producing, replacement of existing plant items and replacement of the CI/DI main and ancillary infrastructure. Tr. 1132. No legitimate rationale that would justify this kind of extraordinary rider treatment was presented by the Companies. Adjusting rates to reflect changes in one element of the test year revenue requirement calculation without examining other (offsetting) expense and revenue components violates this test year rule. This ratemaking precept is yet another reason to reject the Companies' rider proposals, and should be incorporated in the Commission's Analysis and Conclusion on Rider VBA.

As noted earlier in this Brief, based on the case law issued to date, the Commission decisions implementing riders for the recovery of certain expenses have not been reversed by Illinois courts when the expenses at issue are (1) unexpected, volatile or fluctuating, pursuant to *Finkl* and the 1958 *City of Chicago* case, or (2) imposed on the utility by law, pursuant to the *Citizens Utility Board* and *City of Chicago II* cases. As ALJPO correctly noted, compensation for incorporating the depreciation and carrying costs associated with capital investments into base rates does not occur without a rate review proceeding. Because Rider ICR investment is discretionary, no evidence exists to suggest that traditional ratemaking is the kind of "unique cost" requiring rider treatment that the First District Appellate Court affirmed under *City II,* nor is the investment an expense that is unexpected, volatile or fluctuating, as described in *Finkl*.. Moreover, none of the cases in which rider recovery was permitted involved recovery of capital costs, and none involved a base ratemaking proceeding, as is the instant case. A revenue requirement that includes a test year level of plant additions, along with all other revenue requirement components, will be established in this case. There is no need to assess monthly surcharges to ratepayers when the revenue requirement established in this case will permit the Companies to maintain utility infrastructure investment at safe and reliable levels. As Staff aptly noted in its Initial Brief, Rider ICR would require ratepayers to pay a premium for ordinary utility service. That is illegal under the Public Utilities Act, which requires that the public that it pay no more than the reasonable value of the utility's services. *Camelot Utilities, Inc. v. Illinois Commerce Comm'n*, 51 Ill.App.3d 5, 10, 365 N.E.2d 312 (1977; *Citizens Utility Board v. Illinois Commerce Comm'n*, 276 Ill.App.3d 730, 658 N.E.2d 1194 (1995).

The *Finkl* decision also concluded that the rider in question violated the rule against retroactive ratemaking. *Finkl*, 250 Ill.App.3d at 329. Rider ICR violates the prohibition against retroactive ratemaking by permitting monthly and annual rate adjustments after rates are established in this case that are not contemplated by the Public Utilities Act. The Companies' revised Rider ICR examines investment in four plant accounts, but limits qualifying plant for cost recovery to investments that are non-revenue producing, replacement of existing plant items and replacement of the CI/DI main and ancillary infrastructure. Tr. 1132.

As noted earlier in this Brief, Section 9-201 of the Public Utilities Act ensures that rates for utility service are set prospectively. 220 ILCS 5/ 9-201. Once the Commission establishes rates, the Act does not permit refunds if the established rates are too high, or surcharges if the rates are too low. *BPI I*, 136 Ill.2d at 209; *Citizens Utilities Co. v. Illinois Commerce Comm'n*, 124 Ill. 2d 195, 207; 529 N.E.2d 510 (1988).

In addition to the other legal infirmities described earlier in this Brief, the proposed rider ICR violates the prohibition in the Act against retroactive ratemaking. Rider ICR would generate monthly surcharges determined by computing the difference between the average, baseline level of capital additions and Peoples' actual capital expenditures. GCI Ex. MLB-1.8, p. 13 of 13; PGL Ex. JFS-1.0 at 4. Rider QIP would trigger surcharges based upon an increased level of investment in these same main and ancillary infrastructure accounts, with the restrictions noted previously.

In response to Staff testimony, the Company agreed to incorporate an annual reconciliation and prudency review within Rider ICR/QIP. NS/PGL Ex. JFS-1.0 at 5. This retroactive adjustment of rates is not unlike the review ruled illegal in the aforementioned *Finkl* decision, wherein the Illinois Appellate Court specifically rejected Rider 22's adjustment of rates based on a prudency review, calling it a violation of the rule against retroactive ratemaking. *Finkl,* 250 Ill.App.3d 317 at 329.

While reconciliations are permissible and do not constitute illegal retroactive ratemaking for expenses appropriately recovered under a rider, such as Purchased Gas Adjustment Clause proceedings or environmental remediation dockets, reconciliations on both a monthly and annual basis to capture revenue changes are not permitted under the Act or any Illinois case law analyzing rider recovery. Rider VBA is illegal for this reason as well.

Given both the absence of both specific statutory authority authorizing the adjustment of customer rates to reflect accelerated replacement of cast iron main for gas distribution utilities on a monthly basis, the proposed annual reconciliation of Rider ICR revenues reflecting actual expenditures prudently incurred, as well as the rule prohibiting retroactive ratemaking, it is clear the Commission lacks the authority to approve Rider ICR. As such, it should be rejected for this reason, too.

E. Discretionary Rider ICR Investment Is Not the Kind of "Unique" Cost That Would Qualify It For Rider Treatment Under the *City II* Decision.

At page 65 of their BOE, the Companies argue that Rider ICR is designed for the *unique* circumstances relating to main replacement within the City of Chicago. The implication is that Rider ICR costs are the kind of *unique* costs that the *City II* court deemed appropriate for rider recovery.

This comparison is inapposite. As noted above, Rider ICR investment is completely discretionary and within the control of the Company. Unlike the franchise fees approved for rider recovery in *City II,* Rider ICR expenses are not imposed on the utility by law, pursuant to the *Citizens Utility Board* and *City of Chicago II* cases. Moreover, as detailed in all of the AG briefs filed to date, the Company has made clear that Rider ICR investment is not necessary from either a safety or reliability standpoint. *See, e.g.* AG Initial Brief at 75-80. Both the timing and amount of Rider ICR investment would be within the complete control of the Company. Rider ICR would assess monthly surcharges for investment-related costs that are not necessary for the provision of safe, reliable public utility service. This hardly qualifies them as unique and deserving of rider treatment.

F. The Rider ICR Proposal Is *Not* a "New Rate Design Approach"; It Is Nothing Less Than A Request to Radically Revamp How Ratepayers Pay For Utility Service.

In their argument against the Proposed Order's implicit observation that no legal authority exists for approval of Rider ICR, the Companies again proffer the outrageous assertion made in their Rider VBA exceptions, and argue that Rider ICR "is merely a policy decision to employ a new rate design approach, as occurred in *City 1*." PGL/NS BOE at 64.

As noted in the Rider VBA section above, Peoples Gas' and North Shore's proposals to increase the residential heating customer charges by more than 111% and 88% respectively are rate design proposals. Asking for a ratemaking tool that assesses monthly surcharges for discretionary plant investment depreciation and carrying costs that the Company admits is not required for the provision of safe and reliable utility service is nothing less than a radical departure from traditional rate of return regulation and the financing of utility plant investment. The Commission should not tread down that road. Approval of the Company's Rider ICR – and thereby adoption of the Peoples Gas' proposal to alter the way plant investment is financed – would be tantamount to rejection of the well-established utility ratemaking principles that prescribe what is and is not assured to monopoly utilities and ratepayers under the existing regulatory framework.

G. The Company's Modifications To Its Original Rider ICR Proposal Did Not Fix Its Inherent Flaws.

PGL opines at page 63 of the Companies' BOE that Peoples Gas has significantly modified its original Rider ICR proposal to limit its scope and "lend substantial protections to ratepayers." PGL/NS BOE at 63. The modifications made during the case, however, do not ameliorate the proposals inherent legal flaws, nor create a justification for implementing the revised rider.

As thoroughly documented at pages 82-88 of the AG Initial Brief, the modified Rider ICR (sometimes called Rider QIP) is likewise flawed from both practical and legal criteria. Cross-examination of PGL witness James Schott revealed that the proposed cap of 5% of base revenues was meaningless in terms of ratepayer protections. Tr. At 1561-1568; AG Initial Brief at 86-87. In addition, the Companies modest proposal to incorporate leak repair savings into the Rider ICR calculation (which amounts to a nominal a $180,000 to $300,000 offset at most) does not capture all of the other operations and maintenance savings that Company witnesses testified would occur as cast iron mains are replaced. *See* AG Initial Brief at 83-84. Moreover, because Rider ICR –

modified or otherwise – does not fit the criteria for rider recovery articulated in the *Finkl, Citizens Utility Board* and *City II* decisions, the monthly adjustments to rates and prudency review Rider ICR include violate the prohibitions against single-issue and retroactive ratemaking, as well as the Commission's test year rules.

For all of the reasons stated above, in the AG Brief on Exceptions and in the AG Initial and Reply Briefs, Rider ICR – in any of its proposed variations – should be rejected.

VIII. DEFERRED ACCOUNTING ALTERNATIVE

At page 69 of the Brief on Exceptions, the Companies opine that the revenues that would have been collected under Riders VBA and WNA are appropriate for deferral and ultimate recovery in future rate proceedings. PGL/NS BOE at 69. The Companies opine that monitoring and modifying "applicable margin revenues" each month to account for weather fluctuations and changes in usage patterns "would allow the Companies to most closely match the amortization periods of assets (as well as the authorized revenue requirement generally) reflected in the calculations underlying the rates established in this proceeding." *Id.*

This proposition should be rejected for several reasons. First, as thoroughly discussed in the Rider VBA Section of this Brief, there is no need to guarantee the recovery of "margin revenues". Second, the evidence shows that traditional regulation has served the Company well over the last 12 years, and that any so-called business challenge was being aptly addressed under traditional rate of return regulation. *See* AG Initial Brief at 53-67. For example, Peoples Gas earned around or significantly above its authorized return on common equity in eight of the last 12 years. AG Cross (Borgard)

Ex. 3. Similarly, North Shore has consistently earned stable returns, with ROEs ranging from 10.43 to 14.13 percent in all years 1995 through 2005.[9] Moreover, when the Commission establishes a new revenue requirement in this case that will allow the Companies to recover their operating costs as well as a reasonable return on their utility plant investment.

Third, as noted in Staff's Initial Brief, at page 223, the Companies' deferral proposal with respect to Rider VBA/WNA would involve the deferral and future recovery of revenues, a test year component. *See* NS/PGL Ex. VG-2.0 at 50. Accordingly, this treatment would violate the Commission's test year rules, as held by the Illinois Supreme Court in *BPI II.*

In its examination of whether recovery of deferred charges is permissible, the Court examined each category of expense with regard to test year principles. *BPI II*, 146 Ill.2d at 238. The Court concluded that recovery of operating expenses which are subject to test year principles *outside of the test year* violates the Commission's test year principles, and noted that "(t)he purpose of the test year rule is to prevent a utility from overstating its revenue requirement by mismatching low revenue data from one year with high expense data from a different year." *Id.,* 146 Ill.2d at 237-238.

The Companies nevertheless claim that Rider VBA "falls squarely within these noted 'exceptions' to *BPI II* because it allows for the most accurate matching of ratemaking assumptions to weather- and usage-based realities, while preventing rather than promoting any long-term carry-over of costs to future rate case proceedings." PGL/NS BOE at 71. These are nothing more than strawman arguments. As noted repeatedly above, the Companies are not entitled to track monthly revenues to see if they

[9] The exception for North Shore was the year 2000, when its ROE was 5.38 percent. GCI Ex. 1.0 at 19.

match the artificial benchmarks riders VBA and WNA create. State and federal law interpreting public utility ratemaking, as described in the Rider VBA section above and in the AG's Initial Brief (pp. 41-45), neither permit nor require such regulatory guarantees of revenues.

The Companies' deferred accounting proposal for Riders VBA and WNA revenues would recover variations in benchmark revenue amounts outside of the test year, in violation of the test year rules. As noted above, such treatment is not appropriate, based on both the record evidence and Illinois case law. Accordingly, the proposition of deferring and later recovery these revenue streams outside of the test year should be rejected.

IX. RIDER EEP (Merits of Energy Efficiency Program and Rate Treatment)

Beginning at page 73 of their Exceptions, the Commission Staff – the only party to object to the funding of energy efficiency programs ("EEP") in rates -- repeats its arguments against Commission adoption of the Companies' proposed EEP. Staff takes issue with the PO's conclusion that approval of the programs is consistent with the policy goals stated in the Public Utilities Act, and notes that the PUA does not mandate the creation or recovery of EEPs. Staff BOE at 73. The Staff further opines that the decision to permit rate recovery of EEPs rests on whether "the programs make ratepayers better off; i.e. whether the programs result in efficient and least cost public utility service for ratepayers." *Id.* Staff further opines that because no specific programs have been proposed, the Companies cannot guarantee the EEP will result in prudent expenditures. *Id.*

These arguments against adoption of the proposed EEP should be rejected for several reasons. First, utility ratemaking is by nature and law, a prospective process (*see, e.g. Business and Professional People for the Public Interest v. Illinois Commerce Comm'n*, 136 Ill.2d 192, 209, 555 N.E.2d 693 (1989) ("*BPI I*"); *Citizens Utilities Co. v. Illinois Commerce Comm'n*, 124 Ill. 2d 195, 207; 529 N.E.2d 510 (1988)) that precludes the kind of before-the-fact micromanagement Staff seems to be demanding. The Commission's analysis of operating expenses, given the prospective nature of ratemaking, evaluates the kind and dollar amount of the expense being proposed, but for the most part rarely delves into the details of how the dollars are actually spent. For example, when the Commission evaluates a test year amount of office supplies, it typically does not investigate exactly how the budgeted amount is spent. Rather, the typical accounting analysis examines whether the expense itself is necessary for the provision of least-cost utility service and whether the amount requested is a reasonable, "normal" level based on historical experience. In doing so, the Commission intuitively recognizes that all businesses, gas utilities included, for example, require office supplies in order to provide utility service.

A similar analysis should be applied to the proposed EEPs, especially given the fact that no such programs existed in the past for either People or North Shore. The issues involved in the merits and whether to permit ratepayer funding of the proposed $7.5 million EEP are: (1) does the Commission believe EEPs are a necessary component of utility service, and (2) is the amount requested reasonable? The ALJPO correctly answered these questions in the affirmative.

As noted in the AG Initial Brief, the Commission has made clear in the recent Nicor case its conviction that EEPs are a necessary component of utility service. *See* AG Initial Brief at 99, citing ICC Docket No. 04-0779, *Nicor – Proposed Increase in Rates*, Order of September 20, 2005 at 193. The General Assembly, too, has made clear its belief that energy efficiency is an essential ingredient to the provision of utility service. *See* 220 ILCS 5/1-102(a) and (b).

Moreover, by the program's very nature, it was impossible for the Companies to detail the exact programs that would be provided under their proposal, given the fact that the Governance Board oversight structure requires Board approval of specific programs. As noted in the AG Initial Brief, the merger agreement that required the Companies to propose the $7.5 million EEP proposal in this case, also mandated that the Companies work with interested signatories to the settlement agreement for discussions on implementation of the programs prior to the filing of this rate case. *See* AG Initial Brief at 95-99. In an effort to ensure that the energy efficiency programs are developed and marketed by individuals and entities with experience in the implementation of EEPs, the Companies and the aforementioned stakeholders agreed that a third-party Governance Board structure would provide an efficient foundation for program creation and implementation. This structure provides that the Governance Board will oversee the development and approval of specific programs tailored to the needs of the Peoples Gas and North Shore customer bases.

PGL/NS witness Ilze Rukis testified that one of the first things that the Governance Board should accomplish is a market potential study that would further ensure the best and wisest use of available resources by identifying the opportunities to use the funds.[10] Tr. 97. Moreover, given the many layers of oversight built into the proposed Governance Board structure, as well as proposed reporting requirements that would keep the Commission informed as dollars are spent, the substantial evidence of the record supports approval of the $7.5 million EEP.

Staff also argues that the program is funded by all ratepayers, but not all ratepayers benefit. Staff BOE at 74. Accordingly, Staff concludes, the "evidence supporting 'system-wide' benefits is not convincing." *Id.* This complaint is not persuasive for several reasons. First, as noted in the AG Initial Brief, there are a myriad of examples of expenses that are approved for base rate inclusion that arguably do not benefit the entire customer population of various utilities.[11]

Second, according to the Companies' EEP proposal, only ratepayers who are eligible for the $7.5 million initiative -- customers in rate classes 1 and 2 -- would pay for the program. *See* PGL Ex. VG-1.0 at 40; NS Ex. VG-1.0 at 35. Moreover, Staff witness David Rearden, who presented the Staff arguments in opposition to the proposed EEP, acknowledged during cross-examination that all customers within these classes will be free to participate in the program. Tr. 732.

The Staff inequity argument is defective for another reason: it presumes that customer desire and need for EEPs is a static phenomenon. The fact is that customers move in and out of apartments and houses, and their need for energy efficiency assistance

[10] She then listed several types of programs, including technology rebate, door-to-door direct install of free or low cost energy efficiency measures for homes and apartments, low income programs that target selected customer groups to provide assistance to replace inefficient furnaces and water heaters, weatherization measures for both homes and apartments, and shared savings financing, among others, that would likely be a part of the Peoples/North Shore EEP. *See* AG Initial Brief at 95-99.

[11] For example, when Peoples Gas replaces a main on Michigan Avenue, customers who live on Austin Boulevard do not directly benefit from that expenditure. Nevertheless, the capital costs associated with that replacement are included in all customer rates. Similarly, with electric utilities, tree-trimming expenditures do not benefit customers who live in an area with underground distribution lines. Nevertheless, the costs associated with tree-trimming expenses are included in all customers' rates for that particular utility.

and initiatives is ever-changing. Indeed, given the voluntary nature of participation in all EEPs, it is difficult to imagine any EEP that would pass Mr. Rearden's equity test. For all of these reasons, Staff's arguments, miss the mark.

Staff's opposition to approval of EEP as an operating expense is shortsighted and should be rejected because it is inconsistent with this Commission's view of the "critical necessity of using energy efficiency plans as strategic tools to protect Illinois consumers and reduce their energy costs." ICC Docket No. 04-0779, Order at 192.

The Commission should be assured that the proposed Governance Board structure is designed to ensure efficient and prudent spending of EEP dollars. As explained by ELPC witness Kubert, the parties agreed during the collaborative process that took place after the merger settlement that both the Contract Administrator and the Program Administrator(s) would report to the Governance Board. ELPC Ex. 2.0 at 6. In addition, the Program Evaluator would perform periodic audits on the performance of the programs against established performance criteria and also prepare annual reports for the Governance Board. *Id.* Again, the Program Evaluator would be independent of the gas companies, the Contract Administrator and the Program Administrator(s). *Id.* Moreover, the Staff liaison would be a non-voting member of the Board, thereby keeping the Commission apprised of all matters occurring with the Governance Board and its subcontractors. *Id.* at 6-7.

Moreover, Mr. Kubert, who personally participated in the post-merger collaborative process, said the Board would solicit proposals by third-party contractors to implement all or select elements of the EEP, with contractors selected largely based on conclusions as to which bidder can deliver the maximum energy savings relative to available funds. *Id.* at 8. This process would, of course, contribute to the efficiency of the programs. In addition, Mr. Kubert testified that Staff witness David Rearden's proposal to limit administrative costs to 5% is a viable amount. Tr. 1432. The Companies likewise raised no objections to the Commission establishing a cap on administrative costs in any order issued in this proceeding, and the ALJPO adopted this safeguard.

As noted in the AG's Brief on Exceptions, the provision of sustainable energy efficiency programs on the part of the utilities is long overdue, and the People welcome the ALJs' support of the programs proposed in this docket. As noted in the ALJPO, that energy efficiency programs "are consistent with the policy goals contained in the Public Utilities Act"[12], and should be adopted in this docket.

Moreover, for all of the reasons discussed in the AG Brief on Exceptions, the EEP expenses should be incorporated into base rates, rather than through a rider mechanism.

X. COST OF SERVICE --

A. Coincident Peak Versus Average and Peak Average Methods

In their BOE, the Companies object to the adoption in the PO of the Staff and GCI-recommended average and peak ("A&P") methodology for allocating distribution system investment. PGL/NS BOE at 71. To support this objection, the Companies opine that the Commission has adopted other allocation methodologies in past gas company cases and in two recent electric cases, and recommends that the Commission consider its proposed coincident peak ("CP") methodology. *Id.* at 72-74.

These arguments miss the mark and should be rejected. First, the substantial evidence in the record supports adoption of the A&P methodology, which recognizes that

[12] PO at 169, citing 220 ILCS 5/1-102.

while the system is sized primarily to address peak demands, customers use the system throughout the entire year. As discussed in the AG Initial and Reply briefs, CUB/City witness Christopher Thomas, testified that this methodology results in an over-allocation of costs to residential heating customers and should be rejected by the Commission. CUB/City Ex. 1.0 at 72. Staff witness Michael Luth concurred. Staff Ex. 7.0 at 12-17.

As noted in the AG Initial Brief, while there is a relationship between CP demand on the system and the cost of service, Mr. Thomas stated that there is an equally important relationship between average demand and the cost of the system:

> Allocating costs based on CP demand assumes that Peoples and North Shore's distribution systems were designed only to meet CP demands. This methodology further assumes that each customer class would only use the system during a single day of the entire year – the day that demand is the highest. This is clearly not how customers use the distribution system. Customers depend on the distribution system to meet their demands every day, not just when they are using the most natural gas.

CUB/City Ex. 1.0 at 73. This Commission has previously endorsed this viewpoint in several dockets, including ICC Docket Nos. 04-0779, 04-0476, 03-0008, 03-0009, 95-0219 and 94-0040. ICC Staff Ex. 7.0 at 13. Moreover, the Commission has consistently adopted an average and peak ("A&P") methodology for allocating distribution costs in recent gas cases.

The Companies assert that "the facts that customers use gas on days other than the peak…has no mitigating effect on the size and amount of pipe and, consequently, the cost of the pipe that the Utilities must put in the ground." PGL/NS BOE at 74. They add that it is the customers' peak day demand that causes the distribution costs to be incurred and is the proper allocator. *Id.* at 75. However, this sentiment is belied by the testimony of the Companies' own witness, Mr. Doerk, who stated during cross-examination that the

Companies do not immediately construct new facilities to meet increased customer demand that exceeds existing capacity. Tr. at 210-211. As noted in the CUB/City Brief, increased demand from customers can be met by installing equipment on the customer's premises to permit increased throughput at higher pressure. CUB/City Brief at 95, citing Tr. at 213-214.

Moreover, Mr. Thomas testified that the cost of distribution facilities are also a function of usage. CUB/City Ex. 2.0 at 28. Because customers rely on the distribution system to be available every time they desire gas (not just at peak demand), this requirement also drives costs. Mr. Thomas explained that "it is much more accurate to say that the system is designed and installed to meet year-round demand, but should be sized to meet peak demand." *Id.*

The clear precedent established in prior Commission orders adopting the A&P cost allocation methodology, as well as the record evidence supplied by Mssrs. Thomas and Luth in favor of that cost allocation technique, support the conclusion in the ALJPO that the A&P methodology as the more appropriate way to allocate distribution system costs. This conclusion should be retained in the final Order.

B. Allocation of Distribution Plant Account No. 385

The genesis of the Companies' objection to the ALJPO's conclusion that Peoples Gas' Account No. 385 costs should be directly assigned to individual customers is that there are other unnamed account costs that could be directly assigned, but are not, and thus it would be unfair to single out this particular cost for such allocation. PGL/NS BOE at 77-78.

This argument is unpersuasive. The Company admits that it is possible to directly assign the costs, which amount to industrial measuring and regulating station equipment expense. Moreover, as noted in the ALJPO, this allocation involves a very small number of customers. ALJPO at 198. GCI witness Glahn testified that the fact that these customers may move from one classification to another justifies a direct charge. GCI Ex. 6.0 at 5. The recommendation is also in line with the cost allocation and rate design goal of incorporating cost causation into customer rates.

The Companies rationale for not assigning these costs is contradicted by the record evidence, and should be rejected.

XI. RATE DESIGN – Gas Cost-Related Uncollectible Expense

As noted in the AG Brief on Exceptions, the Proposed Order addresses the issue of the appropriate recovery of gas cost related uncollectible expense for retail sales and transportation customers. The PO invites the parties to discuss the matter further in their respective Briefs on Exceptions, although makes clear that Staff's proposed methodology is preferred. Staff's proposed methodology would have sales gas customers in each service classification pay uncollectible gas costs that are based upon how customers in their own service classification affect uncollectible gas costs. To the extent that this methodology spreads the gas cost portion of uncollectible to all rate classes in proportion to their overall percentage of the cost, the People concur with this methodology.

However, special attention need be paid to how these costs are allocated in the per therm charges. As noted at pages 99-101 of the AG Reply Brief, the Companies' proposal, described at pages 160-162 of their Brief, to allocate (1) 78.7% of the uncollectible expense to Rate 1 Heating customers, and (2) then allocate 67% of the rate

1 Heating customers allocated share to the first block volumetric charge, thereby *triggering a nickel increase to this per thermo charge solely for gas cost uncollectible expense*, is inequitable for several reasons, and should be rejected.

First, the allocation of 67% of the residential allocation of uncollectible expense in the first per therm volumetric block is completely arbitrary. There is no support in either the ECOSS or the supporting work papers for this random, first-block allocation. Moreover, the allocation is counter-intuitive to the notion that as usage increases, uncollectible increase. Simply put, the higher the gas bill, the more likely bad debt increases. The Companies' argument in their BOE that this treatment is consistent with their overall proposal for Rate 1H per therm charges is hardly a persuasive basis to exacerbate that rate design. PGL/NS BOE at 81. There simply is no evidence that assigning these costs to the initial per therm block is based on any cost causation principles. Thus, the Companies proposal to allocate 67% of the residential heating customers' allocated cost to this first volumetric block violates cost causation principles as well.

Second, the proposal fails to recognize the Companies agreement to reduce the test year level of uncollectible associated with gas costs by $3.3 million in accordance with Mr. Effort's proposed adjustment. *See* PGL/NS Ex. 2.3. This should be pulled from the gas cost related uncollectible expense test year amount.

Third, the proposed rate design exacerbates the inequities of bifurcating Rate 1 customers into separate rate categories, contributing to the rate shock Residential Heating customers stand to bear if the Companies rate design proposals are approved. Thus, the

Companies' proposal in this regard deviates from the rate design goals of stability and gradualism (and highlights yet another reason to not bifurcate the residential rate class).

Fourth, allocating the lion's share of the cost to this first volumetric block sends customers the wrong price signals regarding usage of natural gas, a nonrenewable energy source. This violates the rate design goal of conservation of resources. *See* GCI Ex. 1.0 at 7. While the Companies argue that the People should have raised this concern within the larger context of declining block per therm rate design, there is no prohibition against raising the issue when that structure's rate effects are amplified. That is exactly what assigning the gas-cost related uncollectible expense to primarily the first block does.

Instead of punishing residential heating customers with higher first block, per therm rates, and ironically possibly contribute to increased, future uncollectible expense, the Commission should analyze this expense for rate design purposes in relation to revenues, consistent with the source of this expense. As noted in the AG Reply Brief, Schedule E-5, Section A, p. 1 provides a breakdown of revenues by customer rate class and could form the basis for allocation of the uncollectible account expense related to purchased gas costs. (The Companies' Rider UBA proposal trumpets the fact that the lion's share of uncollectible costs rises as gas costs (and usage and revenues) rise.) This would have the effect of spreading the uncollectible expense associated with purchased gas costs across the customer rate classes. Second, the expense should be allocated on an equal percentage basis to the number of blocks within each rate class. This alternative to the Companies' gas cost related uncollectible expense allocation satisfies the goals of gradualism, equity and fairness, conservation of resources.

This methodology is preferred to the adoption of Staff's proposal, which appears to not apply this equal percentage basis allocation, and not address the above-stated block concerns about assigning the lion's share of these costs to the Rate 1H first block.

XIX. CONCLUSION

WHEREFORE, for all of the reasons discussed above, the People of the State of Illinois urge the Commission to modify the proposed order in accordance with the arguments set forth above.

Respectfully submitted,

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