STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company d/b/a Nicor Gas Company	)	
	)	Docket No. 08-0XXX
Proposed general increase in rates, and revisions to other terms and conditions of service.	)	

Direct Testimony of

GERALD P. O'CONNOR, FCCA

Senior Vice President Finance and Strategic Planning
Nicor Gas Company

Date: April 29, 2008

Nicor Gas Ex. 12.0

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I. INTRODUCTION AND BACKGROUND

A. WITNESS IDENTIFICATION

Q. Please state your name and business address.

A. Gerald P. O'Connor, 1844 Ferry Road, Naperville, Illinois 60563.

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

A. I am the Senior Vice President of Finance and Strategic Planning for Nicor Inc. and Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor Gas" or the "Company").

B. BACKGROUND AND EXPERIENCE

Q. What are your duties in your position as Senior Vice President of Nicor Gas?

A. I have executive responsibility for several functions within the financial area of Nicor Gas, including the development and administration of Nicor Gas' rates and its financial analysis function. I also am responsible for special projects within the finance area.

Q. Please summarize your educational background and experience.

A. I have a Bachelor's Degree in Commerce from University College, Dublin, Ireland, and a Master of Business Administration from Utah State University. I also am a Chartered Certified Accountant ("FCCA"), which is equivalent in Ireland and the United Kingdom to a Certified Public Accountant ("CPA").

Immediately before joining Nicor Gas in 2004, I was a partner with the consulting firm Tatum Partners, LLC, providing financial consulting services to clients in the utility, investment banking, and energy industries. Prior to joining Tatum Partners, I was a Vice

President and the Chief Financial Officer of Aux Sable Liquid Products, a gas products company. Prior to that, I served for five years as Vice President – Finance and Administration of Illinova Energy Partners, an unregulated energy services company affiliated with Illinois Power Company.

Q. Have you previously testified before the Illinois Commerce Commission ("Commission")?

A. Yes. I testified in the Company's last rate case, Docket No. 04-0779 ("2004 Rate Case").

II. PURPOSE OF TESTIMONY AND SUMMARY OF CONCLUSIONS

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

A. The purpose of my direct testimony is to identify and describe Nicor Gas' five new riders, which are being proposed in response to changing business conditions. Specifically, I discuss the need for the following proposed riders:

- **Uncollectible Expense:** Rider 26, Uncollectible Expense Adjustment ("Rider UEA"), provides for timely recovery of the volatile and significant cost associated with bad debt;

- **Natural Gas Used by Nicor Gas:** Rider 27, Company Use Adjustment ("Rider CUA"), provides for timely recovery of the volatile and significant effects of gas price changes in the cost of natural gas used by the Company in the normal course of its business operations;

- **Volume Balancing Adjustment:** Rider 28, Volume Balancing Adjustment ("Rider VBA"), provides the Company the opportunity to maintain allowed revenues per customer sufficient to recover its fixed costs as approved in this proceeding, despite changes in customer usage from year to year;

- **Energy Efficiency Plan Expenses:** Rider 29, Energy Efficiency Plan ("Rider EEP"), provides for the timely recovery of costs associated with creating and implementing an energy efficiency plan; and

- **Accelerated Infrastructure Replacement Program:** Rider 30, Qualifying Infrastructure Plant ("Rider QIP"), provides for the recovery of the cost of and the return on investment arising from the Company's program to accelerate the replacement of cast iron main and copper services.

Q. What is the conclusion of your direct testimony?

A. I conclude that each of these riders is necessary to address a specific business condition facing Nicor Gas both now and in the future. The proposed riders are reasonable approaches to cost recovery. They would permit Nicor Gas the opportunity to recover its prudent costs of providing safe and reliable service, while maintaining the Commission's important role in setting rates.

Q. Why is Nicor Gas requesting approval of these proposed riders?

A. Nicor Gas is proposing these riders for several reasons:

Riders UEA and CUA: Natural gas prices are subject to significant year-to-year volatility that is beyond the prudent management of the Company. This volatility has had a substantial negative impact on the Company's opportunity to recover its gas-related costs, as natural gas prices directly affect the Company's cost of gas used for operations and the level of its Uncollectible Expense.

Riders VBA and EEP: A continuing decline in gas deliveries, (*e.g.*, due to the effects of conservation, economic conditions and weather) also has a direct impact on the Company's ability to recover its fixed costs. Moreover, under current rate design, an effective energy efficiency plan will have an adverse financial impact on the Company because it will lead to lower delivery volumes. Indeed, absent an appropriate rate design, the Company will not have a fair opportunity to recover its Commission-approved costs. Meanwhile, a rate design that breaks the direct link between delivery volumes and the

Company's recovery of fixed costs creates the proper incentives to make conservation a shared goal of the Company and its customers. It also allows the Company to propose and support a funding mechanism for energy efficiency programs.

Rider QIP: The establishment of an appropriate cost recovery mechanism which allows the Company to recover certain additional capital investments in a timely fashion will facilitate Nicor Gas' ongoing replacement of its old cast iron main and copper services. From 2005 through 2007, the Company replaced approximately 15 miles of cast iron main and 3,500 copper services per year under a program that prioritizes replacements on a risk-based approach. At this replacement rate, it would take until 2040, or approximately 32 years, to complete the replacement of all cast iron main and copper services in the Company's system. For 2008 and 2009, the Company will replace approximately 40 miles of cast iron main and approximately 9,000 copper services each year. However, it would not be economically feasible for the Company to continue to maintain this accelerated pace beyond the test year absent the ability to recover a return of and on these additional investments prior to the completion of a future rate case.

III. RIDERS AS COST RECOVERY MECHANISMS

Q. Please explain, in general terms, how riders are used in public utility regulation to recover costs and for other purposes.

A. Riders traditionally have been used to provide utilities with a reasonable opportunity to recover specific costs that do not easily fit into the test-year approach to ratemaking. One reason these costs do not fit into the test-year approach is that they are volatile, significant and are largely out of the control of the utility. Riders are designed such that specific costs are recovered in a timely manner, and customers only are charged for the

reasonable and prudent costs actually incurred. For those riders, like Riders UEA and CUA, that set charges based on actual costs as opposed to the test-year costs, a symmetry is created between ratepayers and utilities with respect to costs. Ratepayers may receive a credit when actual costs fall below test-year costs, while utilities recover their prudently incurred costs, and no more.

More recently, riders have been authorized in Illinois and other jurisdictions to address the unique nature of certain costs. For example, the historic approach to rate design has over-allocated fixed costs to volumetric rates. This approach impairs the opportunity to recover prudently incurred costs, not as a result of any deficiency on the part of the utility, but as a result of lower volumes delivered to end-users than those assumed in establishing base rates. The Commission recognized this precise problem when approving Rider VBA in North Shore Gas Company and The Peoples Gas Light and Coke Company rate cases in consolidated Docket Nos. 07-0241 and 07-0242 (the "Peoples Rate Case").

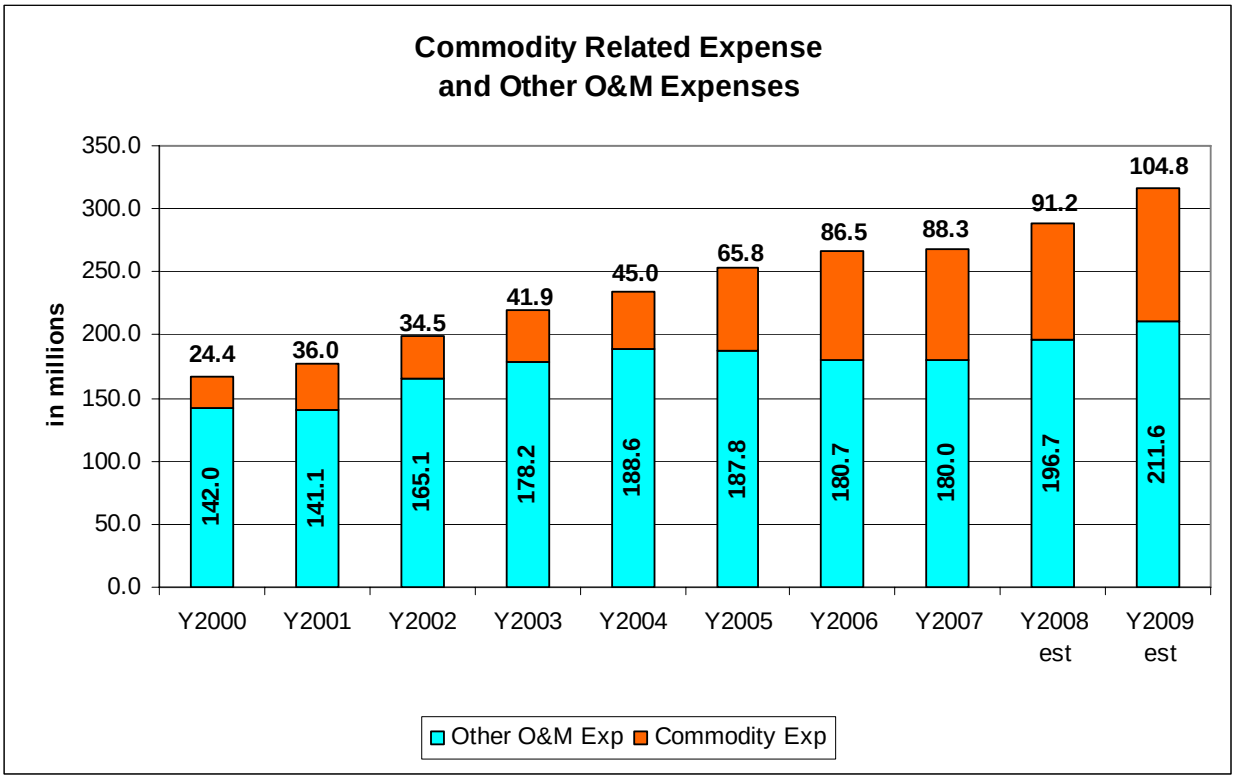
In sum, cost recovery riders are part of the traditional ratemaking approach that has been used in Illinois, and other jurisdictions, for decades. These riders better track costs with prices and provide for the timely recovery of those costs. Volume balancing adjustment riders serve an equally important function by providing a mechanism to allow utilities, in the face of declining deliveries, to continue to collect sufficient level of revenues to recover their fixed costs reflected in base rates and to directly align with customers in promoting lower usage through conservation.

IV. EXPENSE RECOVERY RIDERS (RIDERS UEA AND CUA)

Q. What is the major driver affecting Nicor Gas' expenses at this time?

A. Natural gas prices are the most important factor affecting the Company's expenses. Natural gas prices are very volatile when compared to other operating and maintenance ("O&M") expenses and have become a much larger percentage of Nicor Gas' total O&M expenses recovered through base rates. As depicted in Figure 1 below, the annualized increase in natural gas-related O&M expenses during the period 2000 to 2009 was 17.6%, compared to 4.5% for other O&M expenses during that same period.

FIGURE 1.



Q. What expense items are significantly affected by gas prices?

A. There are three items. First, is the cost of gas used in Company operations ("Company Use"). For purposes of my testimony, Company Use gas does not include franchise gas cost. Second, is the cost associated with bad debt ("Uncollectible Expense"). Third, is

the cost associated with gas supplied to municipalities under franchise agreements. The proposed treatment of franchise gas cost is addressed in the direct testimony of Nicor Gas witness Robert R. Mudra. (Nicor Gas Ex. 14.0).

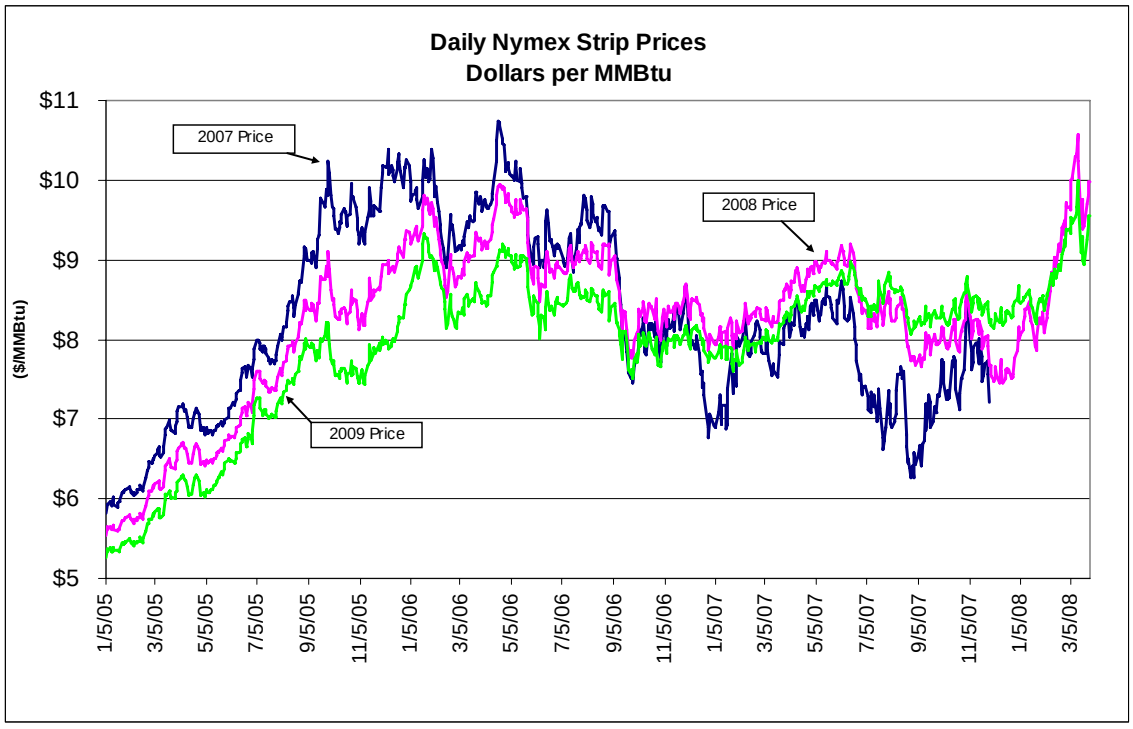
Q. How do gas price fluctuations affect the cost of gas used in Company facilities?

A. There is a direct dollar-for-dollar relationship. For each $1.00 per MMBtu increase or decrease in the price of gas, there will be a corresponding increase or decrease of a $1.00 per MMBtu in the cost for Company Use gas. Nicor Gas purchases approximately 3,100,000 MMBtu of gas for Company Use annually. Accordingly, a $1.00 per MMBtu price change would equate to an increase or decrease of $3.1 million in Company Use expense. Given recent historical trading ranges for natural gas, gas price movements greater than $1.00 per MMBtu can be expected.

Q. You have indicated that gas prices are very volatile. Can you illustrate this volatility?

A. Yes. Figure 2 below provides a graphic illustration based upon recent historical New York Mercantile Exchange ("Nymex") trading prices.

FIGURE 2:



Q. Could you please explain what Figure 2 shows?

A. Figure 2 demonstrates the volatility of natural gas prices. The graph plots the average of Nymex closing prices of natural gas for delivery in future years (2007 – 2009) or remainders of years (2007 – 2008), as settled daily from January 2005 through the beginning of April 2008. The range of volatility in natural gas prices is clearly depicted. For example, as shown by the 2007 Futures line, the average of the 2007 Nymex Futures contracts rose from a low of under $6 per MMBtu in January 2005 to almost $11 per MMBtu in April 2006. Similarly, the average of the 2009 Nymex Futures contracts rose from approximately $5.20 per MMBtu in January 2005 to a high of almost $10 in March 2008.

As discussed elsewhere in my testimony, the impact of this volatility on Nicor Gas' combined Company Use and Uncollectible Expense is approximately $8 million per dollar change in price.

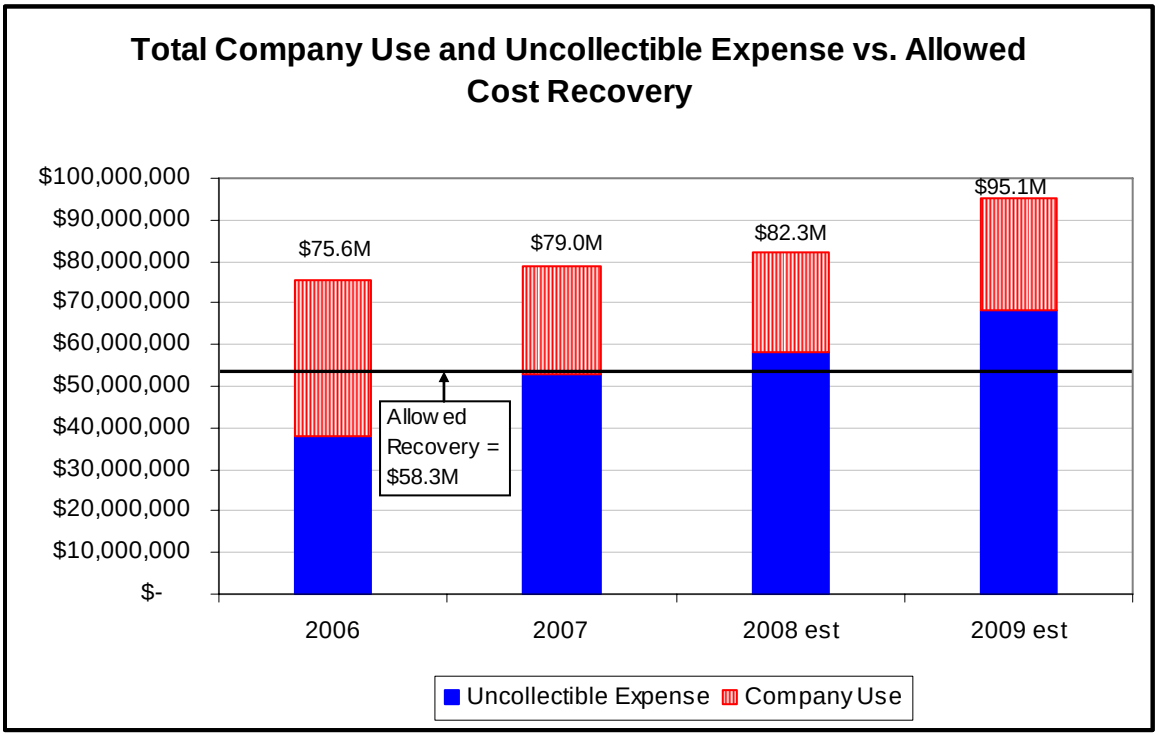
Q. How do gas price fluctuations impact Uncollectible Expense?

A. While not a direct dollar-to-dollar relationship, as described below, there is a significant and closely correlated relationship between Uncollectible Expense and natural gas prices. For each $1.00 per MMBtu increase or decrease in the price of gas, there is an increase or decrease of approximately $5.5 million for Nicor Gas' expected Uncollectible Expense.

Q. What has been the combined impact of Uncollectible Expense and Company Use expense on the Company?

A. The Company's combined Uncollectible Expense and Company Use expense have been consistently and substantially higher than the combined amount of these expenses allowed in the 2004 Rate Case, as illustrated in Figure 3 below**.**

FIGURE 3



Q. Please describe what is shown in Figure 3.

A. Figure 3 is a stacked bar graph showing the historical and forecasted annual Company Use expense and Uncollectible Expense. The solid horizontal line represents the combined cost recovery allowed in the 2004 Rate Case. In sum, this Figure illustrates that the level of expense the Company has incurred and is forecast to incur, for Company Use and Uncollectible Expense, is well in excess of what was approved in the 2004 Rate Case.

A. RIDER 26: UNCOLLECTIBLE EXPENSE ADJUSTMENT

Q. In general, what is the purpose of proposed Rider UEA?

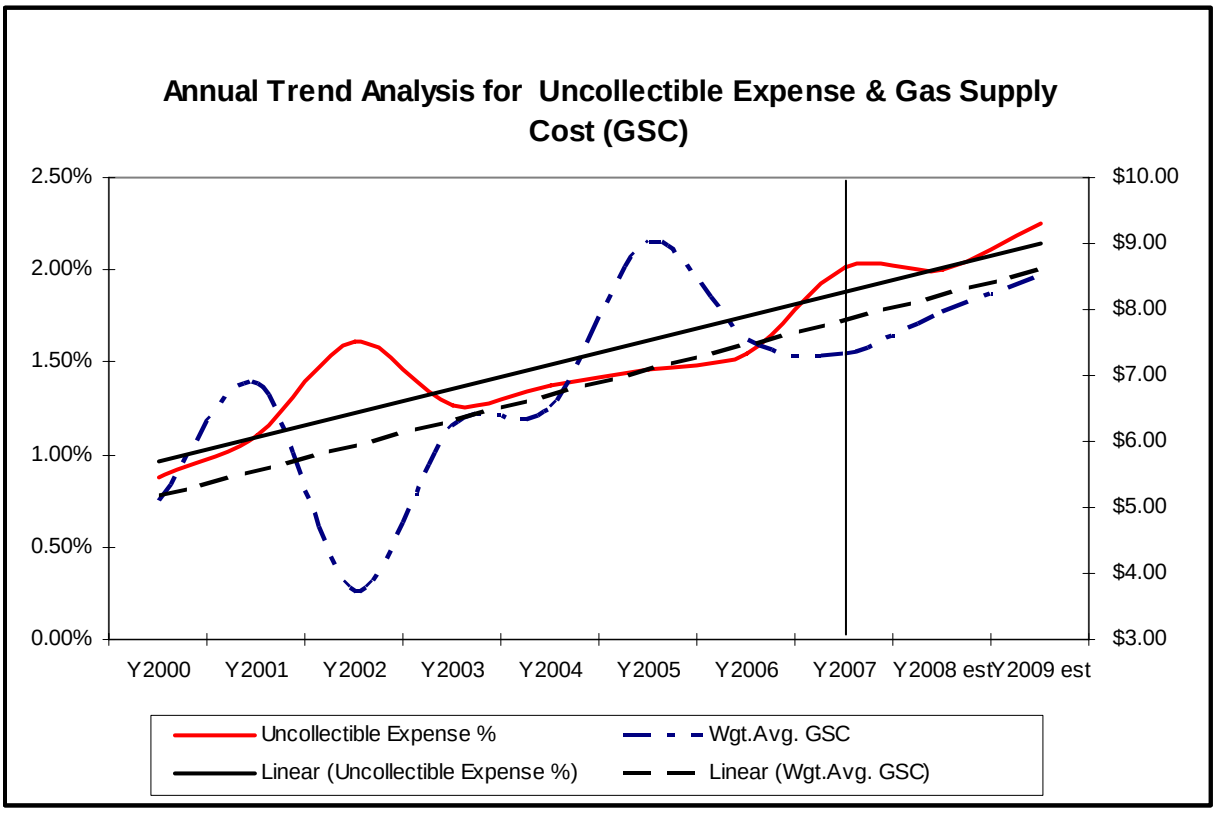
A. Rider UEA addresses the impact volatile gas prices have on Uncollectible Expense. The costs that comprise Uncollectible Expense are closely correlated to natural gas prices,

which are volatile, and largely outside the control of Nicor Gas' management. Further, these costs are significant in terms of Nicor Gas' overall operating costs and affect the Company's ability to recover its allowed costs.

Q. Please explain what is shown on Figure 4.

A. Figure 4 compares the volatility and rise of Nicor Gas' provision for bad debt, or Uncollectible Expense, with the Company's actual and forecasted gas supply cost charges from the year 2000 to year 2009. As is evidenced by the linear trend lines from the chart, there is a close correlation between the rise in gas prices and the rise in Uncollectible Expense.

FIGURE 4



Q. What has been the recent trend in Uncollectible Expense?

A. As discussed in the direct testimony of Nicor Gas witnesses Kevin W. Kirby and James M. Gorenz (Nicor Gas Exs. 6.0 and 11.0, respectively), Uncollectible Expense has become a significant portion of Nicor Gas' operating expenses, rising from a level of approximately $38.5 million approved in the 2004 Rate Case to $53 million in 2007, and to approximately $68.3 million projected in the test year. Not only has the dollar level of Uncollectible Expense risen, but the rate at which revenue billed becomes uncollectible also has risen, from the 1.40% applied in the 2004 Rate Case to 2.02% in 2007, and to 2.25% projected in the 2009 test year.

Q. Please describe, in general terms, how proposed Rider UEA would work.

A. Annually, Nicor Gas would compare the amount of authorized Uncollectible Expense provided for in its base rates with its actual expense. Rider UEA would use the amount of Uncollectible Expense approved by the Commission in this proceeding as a base starting point. Nicor Gas proposes a plus or minus 5% dead-band around the authorized amount. If the actual amount of Uncollectible Expense falls within the dead-band, there would be no adjustment. If actual expenses exceed the base amount by more than 5%, the amount in excess of the dead-band would be collected from ratepayers from April through December of the following year. Likewise, if actual expenses are lower than 95% of the base amount, the amount outside the dead-band would be returned to ratepayers. Mr. Mudra discusses the mechanics of Rider UEA in his testimony. (Nicor Gas Ex. 14.0).

Q. Would Rider UEA remove an incentive for Nicor Gas to manage the credit and collections function effectively?

A No. Nicor Gas would remain committed and incented to minimize Uncollectible Expense because of the proposed rider's dead-band design. Nicor Gas would remain responsible for any amount above the Uncollectible Expense amount authorized for inclusion in base rates up to an additional 5%. Based on the Company forecast of approximately $71.5 million of Uncollectible Expense for the 2009 test year at proposed rates, the Company would be responsible for bearing nearly $3.6 million of additional Uncollectible Expense in a given year before any additional charges would be assessed to customers under Rider UEA.

Q. What benefits would Rider UEA provide to ratepayers?

A. Rider UEA would reduce customer charges in the event the costs that comprise Uncollectible Expense are reduced beyond the band width of the rider. As previously discussed, the Uncollectible Expense amount approved in the 2004 Rate Case was $38.5 million. If the Company's actual Uncollectible Expense costs were again to decline to that level in a subsequent year, customers would be entitled to receive a credit of nearly $29.5 million under Rider UEA. Without Rider UEA, customers would not receive any refund based upon this reduced cost. Given the volatility of natural gas prices, it is certainly conceivable that the Company's Uncollectible Expense could decline significantly from its forecasted test year amount in one year, only to climb again to a level at or above the forecasted test year amount in subsequent years. As such, there is no guarantee that a reduction in Uncollectible Expense realized in one year will have any impact on the level of Uncollectible Expense approved for the Company in a subsequent rate case.

Q. How would Rider UEA impact Nicor Gas?

A. The rider would allow Nicor Gas the opportunity to address, in a fair and timely manner, natural gas price volatility and its impact on Uncollectible Expense, a major driver for Nicor Gas' rate relief request. Rider UEA is a balanced, fair and reasonable means of addressing a significant challenge facing the Company.

Q. From a policy perspective, why should the Commission approve Rider UEA?

A. Uncollectible Expense, which represents more than 21% of the Company's forecasted O&M for the 2009 test year, clearly is a significant cost to the Company. The level of Uncollectible Expense experienced is largely dictated by natural gas prices, a factor that is not within the Company's control. Natural gas prices are volatile, which, in turn, means that the level of Uncollectible Expense for the test year likely will not be predictive of the level of Uncollectible Expense that will be experienced in subsequent years. As previously discussed, cost recovery riders are particularly appropriate for expenses that are significant, volatile and not within the ability of the utility to control.

Rider UEA is designed to be fair and equitable to both Nicor Gas and its customers. It provides Nicor Gas a reasonable opportunity to recover its actual uncollectible costs and, through the dead-band feature, also creates strong incentives for Nicor Gas to do all it can to manage those costs effectively. Rider UEA also benefits customers by providing them the opportunity to receive a reduction in their bills if Uncollectible Expense fall below 95% of the amount approved in base rates in the test year. In summary, the Commission should approve Rider UEA because Uncollectible Expense costs are suitable for recovery through a rider and the methodology for recovery proposed by Rider UEA is fair and equitable to Nicor Gas and its customers.

B. RIDER 27: COMPANY USE GAS COST ADJUSTMENT

Q. How is Nicor Gas proposing to address the uncertainty surrounding future Company Use expenses caused by natural gas price volatility?

A. Nicor Gas is proposing Rider CUA.

Q. Please identify the expenses included in Company Use that Nicor Gas is proposing to recover through the rider.

A As used in determining the charges under Rider CUA, Company Use gas would be comprised of natural gas consumed by Nicor Gas in the provision of natural gas distribution service to customers. This amount would include gas used to run the compressor units at storage fields, gas consumed in the operation of the storage fields (other than compressor fuel), and gas used in Company buildings and other operating facilities.

Q. Please explain the purpose of Rider CUA.

A. Company Use costs are directly related to natural gas prices, which are unpredictable, volatile and outside the control of Nicor Gas. Moreover, these costs are significant in terms of Nicor Gas' overall operating costs. Rider CUA would address the impact of gas price volatility associated with recovering the costs of Company Use gas between rate proceedings.

Q. Please describe, in general terms, how proposed Rider CUA would work.

A. Annually, Nicor Gas would calculate the impact that gas price changes have had on the cost for Company Use gas. In determining the amount of the charge or refund, Rider CUA would take the actual average price of natural gas for the year times the number of

therms approved in this case to establish "total cost". This amount is then compared to the amount approved in this case, and the difference is then recovered or refunded through the rider. Mr. Mudra discusses in detail the mechanics of Rider CUA in his testimony. (Nicor Gas Ex. 14.0).

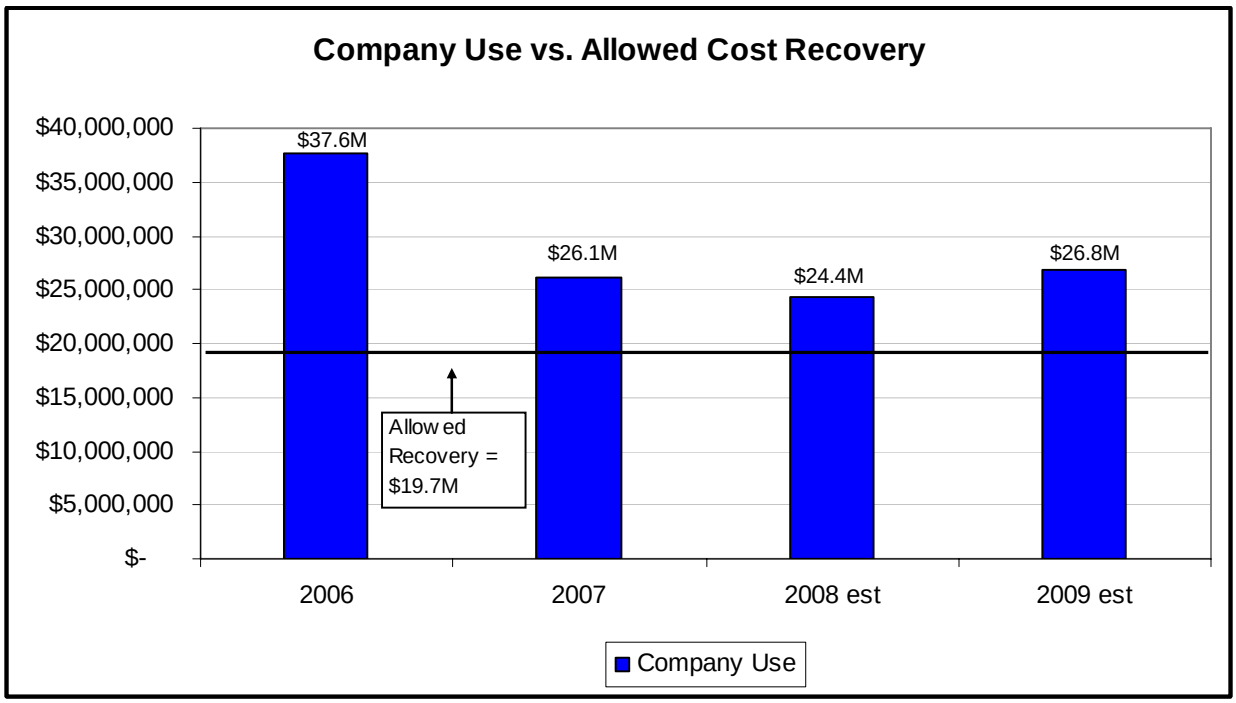
Q. Would Rider CUA remove an incentive for Nicor Gas to manage Company Use costs effectively?

A. No. Nicor Gas would continue to have the incentive to manage Company Use costs effectively because Rider CUA does not address changes in the quantity of Company Use gas consumed. Nicor Gas would not recover in rates any of the costs associated with quantities of Company Use gas actually consumed in excess of the quantity used to establish base rates. As such, it would be in Nicor Gas' economic interest to maintain or reduce the quantity of Company Use gas required for its operations. It also would continue to be in Nicor Gas' economic interest to continue to purchase gas used for Company Use prudently because there would be no rate recovery for the cost of any portion of that gas in excess of the quantity reflected in base rates.

Q. Do you have supporting information for the change in Company Use expense over the past several years?

A. Yes. Figure 5 below shows the Company Use expense approved in the 2004 Rate Case, the actual Company Use expense for 2006 and 2007, and the forecasted Company Use expense for 2008 and 2009.

FIGURE 5



Q. Do you have supporting information for the impact changes in gas prices has on Company Use expense?

A. Yes. Company Use expense changes by approximately $3.1 million for each $1.00 change in the per MMBtu price of gas. The volatility in gas futures prices over the last several years demonstrates the potential for swings in gas prices much larger than $1.00 per MMBtu.

Q. What benefits would Rider CUA provide to ratepayers?

A. Rider CUA would reduce customer charges for Company Use at times when gas prices fall below the level used to set base rates in this proceeding. Without proposed Rider CUA, customers would not have an opportunity to receive the benefit from a reduction in this cost. Given the volatility of natural gas prices, it is certainly conceivable that

Company Use expense could decline significantly from our forecasted test year amount in one year, only to climb again to a level at or above the forecasted test year amount in subsequent years. As such, there is no guarantee that a reduction in Company Use expense realized in one year will have any impact on the level of Company Use expense approved for the Company in a subsequent rate case.

Q. How would Rider CUA impact Nicor Gas?

A. Rider CUA would allow Nicor Gas the opportunity to address, in a fair and timely manner, natural gas price volatility and its impact on Company Use expense, a major driver for Nicor Gas' rate relief request.

Q. From a policy perspective, why should the Commission approve Rider CUA?

A. Company Use expense is a significant cost to Nicor Gas. The level of Company Use expense experienced is driven by natural gas prices, a factor that is not within the control of the Company. Natural gas prices, in turn, are volatile which means that the level of Company Use expense for the test year likely will not be predictive of the level of Company Use expense that will be experienced in subsequent years. As previously discussed, cost recovery riders are particularly appropriate for expenses that are significant, volatile and not within the ability of the utility to control.

Rider CUA is designed to be fair and equitable both to Nicor Gas and its customers. It provides Nicor Gas a reasonable opportunity to recover its actual costs for Company Use and, because it only applies to changes in gas prices and not to changes in volumes of Company Use gas consumed, also creates a strong incentive for Nicor Gas to do all it can to manage those costs effectively. Rider CUA also benefits the Company's

customers by providing them the opportunity to receive a reduction in their bills if gas prices fall below the gas price used to calculate the amount of Company Use expense included in base rates. In summary, the Commission should approve Rider CUA because Company Use expense is suitable for recovery through a rider and the methodology for recovery proposed by Rider CUA is fair and equitable to Nicor Gas and its customers.

V. VOLUME BALANCING ADJUSTMENT AND ENERGY EFFICIENCY RIDERS (RIDERS VBA AND EEP)

Q. Please explain how the amount of gas the Company delivers impacts its opportunity to recover its costs.

A. At the outset, it is important to recognize that most of the operating costs included in the Company's base rates are fixed costs. That is, they are costs that the Company will incur without regard to the volume of gas it delivers to customers. Nonetheless, under the Company's current rate design, a substantial portion of these fixed operating costs are collected through charges customers only pay on the actual volumes of gas delivered to them. These volumetric charges were set in the 2004 Rate Case based on the total volume of gas the Company was expected to deliver on an annual basis assuming normal weather conditions. However, the Company will not generate sufficient revenue in a given year to recover fully its fixed costs approved in the 2004 Rate Case if it delivers lower volumes than were used in the design of its volumetric charges.

Q. Is it correct, then, that energy conservation by the Company's customers affects the ability of the Company to recover its fixed costs?

A. Yes. Nicor Gas appreciates the importance of energy conservation by its customers and supports such efforts. However, based upon Nicor Gas' existing rate design, energy

conservation has a negative effect on the Company's ability to recover its fixed costs. As shown in the direct testimony of Nicor Gas witness Richard L. Hawley (Nicor Gas Ex. 1.0), per customer gas consumption for the Company's residential and non-residential customers has been declining for many years. The success of energy conservation, however, results in lower deliveries and less revenue for Nicor Gas.

Q. Can you quantify how declining customer usage has affected Nicor Gas' ability to recover its operating revenue authorized by the Commission in the 2004 Rate Case?

A. In the 2004 Rate Case, average normalized gas consumption per residential space heating customer for the residential class was 1,183 therms. By 2009, average normalized consumption per space heating customer will have decreased 95 therms to 1,088 therms. Considering that Nicor Gas has about 1.9 million residential space heating customers, that amounts to a loss in deliveries of about 187 million therms annually which, at the Company's current rates, translates into a base revenue loss of about $9.7 million annually.

Q. Is this situation unique to Nicor Gas?

A. No. It is a national phenomenon and is certainly not limited to Nicor Gas' service territory.

Q. Does this mean that programs to promote energy conservation must necessarily conflict with the financial interests of the Company?

A. No. The answer is to design rates so that the Company can collect the revenue needed to recover its approved fixed operating costs, even as deliveries decline. A rate design that would "de-couple" revenue from deliveries would place the Company in a better position

to facilitate new energy efficiency initiatives by removing the existing financial disincentive to do so.

Q. How is Nicor Gas proposing to address the issue?

A. Nicor Gas is proposing Rider VBA, a revenue stabilization or "de-coupling" mechanism, consistent with similar riders previously approved by the Commission. Nicor Gas also is proposing Rider EEP as a funding mechanism for a new energy efficiency plan to promote increased conservation by its customers. Together, these two new riders promote increased energy efficiency in a manner that is a "win-win" situation for Nicor Gas and its customers.

A. RIDER 28: VOLUME BALANCING ADJUSTMENT

Q. Has the Commission approved a volume balancing adjustment mechanism like Nicor Gas' proposed Rider VBA?

A. Yes. The Commission approved a volume balancing adjustment rider in the Peoples Rate Case.

Q. Please provide a general description of proposed Rider VBA.

A. In general terms, Rider VBA would make monthly adjustments for the difference between average base distribution revenue per customer, as determined in this proceeding, and actual average base distribution revenue per customer. Base distribution revenue refers to revenue derived from the volumetric charges to customers. It does not include monthly customer charge revenue, the commodity cost of gas, environmental cost recovery, taxes and other such revenues. Once the difference between the rate case determined base distribution revenue per customer and actual base distribution revenue

per customer is determined for a month, the difference is then multiplied by the number of customers as determined in this proceeding to get a total revenue adjustment. This total revenue adjustment is then divided by the forecasted therm deliveries for the next month and will result in either a charge or a credit to customers.

Q. Does this mean that Rider VBA will increase a customer's bill even though that customer is conserving and using less gas?

A. Absolutely not. In that situation, the customer will realize the costs savings associated with the reduction in the amount of gas consumed. In other words, the gas cost portion of the customer's bill, which comprises approximately 80% of a customer's total bill, will be reduced because the customer is consuming less gas. It is only the delivery portion of the customer's bill, or less than 20% of the total bill, that is subject to adjustment under Rider VBA.

Q. Could you explain what impact weather has under Rider VBA?

A. Rider VBA makes monthly adjustments to customer delivery charges based on differences between the average distribution revenue per customer assumed in setting rates in this proceeding and the actual average distribution revenue per customer that is received in a given month. The average distribution revenues per customer assumed in this proceeding will be determined based upon normal weather conditions. Everything else being equal, weather that is colder than normal equates to higher deliveries and higher revenues, and warmer weather means lower deliveries and lower revenues. Accordingly, Rider VBA adjusts for the effects of weather, as well as those of energy conservation.

Q. What benefits would ratepayers receive from Rider VBA?

A. Ratepayers benefit in two ways. First, Rider VBA solves the rate design problem that serves as an impediment to energy conservation. No one questions that energy conservation is in the public interest and the best interest of ratepayers. However, current rate design penalizes Nicor Gas financially for successful conservation efforts. Rider VBA aligns Nicor Gas' position with the interests of its customers to support robust energy conservation efforts. Second, ratepayers likely would benefit from Rider VBA by receiving some relief from higher gas bills during periods when the weather is colder than normal. For a month with colder than normal weather, Rider VBA would act to offset higher gas bills by providing a bill credit in future months.

Q. How does Rider VBA impact Nicor Gas?

A. Current rate design places Nicor Gas in a difficult position with respect to energy conservation. Under current rates, the Company is rewarded financially by increased gas consumption by its customers and penalized financially by decreased gas consumption. Rider VBA addresses this problem by de-coupling the revenue that the Company needs to recover fully its fixed operating costs from delivery volumes.

Q. Is Nicor Gas taking other actions, in addition to proposing Rider VBA, to ameliorate the impact on declining deliveries and distribution revenue?

A. Yes. As discussed more fully in the rate design testimony presented by Mr. Mudra (Nicor Gas Ex. 14.0), Nicor Gas is proposing to adjust its monthly customer charges in each rate class to recover a larger portion of its fixed operating costs through fixed charges.

Q. Would this adjustment to the monthly customer charges, if approved, eliminate the need for Rider VBA?

A. No. Even with the proposed shift of additional fixed operating costs to monthly customer charges, a significant amount of fixed operating costs would still be recovered through volumetric charges. While the amount of the Company's exposure to revenue loss due to reduced deliveries would be mitigated somewhat, it would by no means be eliminated.

Q. What is Nicor Gas' position on implementing a Straight Fixed Variable ("SFV") rate design?

A. Nicor Gas is in favor of a SFV rate design which recovers all fixed costs with fixed charges, such as monthly customer charges. On balance, there may be additional administrative efficiencies associated with a SFV rate design that are not attendant with Rider VBA. Nicor Gas would be supportive of a Commission order that would implement a SFV rate design in lieu of Nicor Gas' proposed Rider VBA. Nicor Gas already is moving toward a SFV rate design with its proposed adjustment to monthly customer charges. In the interim, Rider VBA is an appropriate mechanism to assist in the recovery of the Company's fixed costs.

Q. From a policy perspective, why should the Commission approve Rider VBA?

A. The Company's current rate design does not promote energy conservation. Rider VBA is being offered as a four-year pilot program and promotes Nicor Gas' partnership with its customers to achieve further energy conservation gains. Rider VBA also benefits the Company's customers by providing credits when weather is colder than normal and gas bills are likely to be high. In summary, the Commission should approve Rider VBA

because it is an appropriate rate design solution that balances the promotion of energy conservation with the need to provide the Company with the opportunity to recover its fixed costs.

B. RIDER 29: ENERGY EFFICIENCY PLAN

Q. What action is Nicor Gas proposing to take with respect to energy conservation?

A. In concert with Rider VBA, Nicor Gas is voluntarily proposing a four-year pilot energy efficiency plan. Rider EEP provides for the recovery of the costs associated with the Company's energy efficiency plan.

Q. Has the Commission approved an energy efficiency plan and recovery mechanism similar to what Nicor Gas is proposing?

A. Yes. In the Peoples Rate Case, the Commission approved a substantially similar energy efficiency plan and cost recovery rider.

Q. Please provide a general description of proposed Rider EEP.

A. Rider EEP would annually collect the cost associated with the approved efficiency plan. As with the programs in the Peoples Rate Case, Nicor Gas does not propose to be an operator of conservation programs. Rather, Nicor Gas would be a conduit to recover the funds necessary to operate the programs. A more detailed explanation of the Company's proposed energy efficiency plan is found in the direct testimony of Nicor Gas witness Kristine J. Nichols. (Nicor Gas Ex. 13.0).

Q. Which rate classes would be affected by Rider EEP?

A. Nicor Gas proposes that Rider EEP apply to Rate 1 (Residential Service), Rate 4 (General Service) and Rate 74 (General Transportation Service). Nicor Gas' proposed Rider VBA

is applicable to only Rates 1, 4 and 74 and thus, it is appropriate that any energy efficiency programs also be geared toward these classes.

Q. Please explain why it is appropriate to spread the costs of Nicor Gas' proposed energy efficiency plan to all Rate 1, 4 and 74 customers.

A. It is appropriate to spread the costs of the energy efficiency plan to all residential and commercial ratepayers primarily because all ratepayers would have access to and can benefit from energy efficiency programs. Further, due to the variety of conditions each home or business owner is subject to, each individual Nicor Gas customer will be in a much better position to determine for themselves how to best spend their money for energy efficiency. The energy efficiency plan would be designed to educate, motivate, and enable more efficiency opportunities than would otherwise be implemented. However, Nicor Gas believes the ratepayer should be the ultimate decision-maker on what is to be implemented. Finally, customers who choose not to participate in any of the available programs can still benefit from a cleaner environment; the societal benefit of energy efficiency programs.

Q. Would Nicor Gas consider offering Rider EEP if the Commission does not approve Rider VBA?

A. Rider EEP contains a provision that allows Nicor Gas to recover lost revenue due to reduced deliveries resulting from conservation by its customers through specific conservation programs implemented pursuant to Rider EEP. This provision would, of course, be unnecessary if Rider VBA is approved by the Commission. If Rider VBA is not approved by the Commission, this provision in Rider EEP would remain to provide a

mechanism for Nicor Gas to recapture revenue lost due to the operation of approved conservation programs.

Q. If Rider VBA is not approved, how would Nicor Gas determine how much revenue would be lost due to approved conservation programs?

A. In that instance, Nicor Gas proposes that as part of a Program Implementer's request for approval, the Program Implementer would give estimates of the amount of conservation, in terms of therm savings, the program is anticipated to generate. These values could be used to determine the therm reduction and base revenue lost for each program. Nicor Gas would then include this amount in its calculation of the amount of money to be recovered from ratepayers.

Q. From a policy perspective, why should the Commission approve Rider EEP?

A. There is no serious debate that increased energy conservation is a worthy public policy goal and that it is of great importance to the Commission, ratepayers and the State of Illinois. Rider EEP and the Company's proposed energy efficiency plan are modeled after the plan and rider considered and approved by the Commission in the Peoples Rate Case. Simply stated, Rider EEP is an appropriately structured mechanism to provide funding for the development of energy conservation programs in the Company's service territory and should be approved by the Commission.

VI. CAPITAL INVESTMENT COST RECOVERY RIDER (RIDER QIP)

Q. What action is Nicor Gas proposing to take with respect to old cast iron main and copper services?

A. The Company proposes Rider QIP, which is designed to recover the return on and of the incremental annual capital investment under an accelerated replacement program. The accelerated program is tailored to the replacement of cast iron main and copper services. The annual expenditures for the program are tied to an incremental increase in the number of miles of cast iron main replaced and an incremental increase in the number of copper services that are replaced.

Q. Please describe the Company's ongoing program for replacement of cast iron main and copper services.

A. As discussed more fully in the direct testimony of Nicor Gas witness Anthony R. McCain (Nicor Gas Ex. 5.0), the Company has utilized a risk-based approach to prioritize the replacement of its cast iron main and copper services. This has resulted in the replacement, on average, of approximately 15 miles of cast iron main and 3,500 copper services per year for the period from 2005 through 2007. At those replacement rates, the process to replace all cast iron main and copper services would take approximately 32 years to complete. The Company budgeted for and initiated an accelerated program for 2008 and 2009, under which approximately 40 miles of cast iron main and 9,000 copper services will be replaced each year. However, the Company cannot maintain this accelerated rate of replacement without a mechanism to ensure timely recovery of the incremental capital investments.

Q. Is Nicor Gas proposing to continue its accelerated program for replacement of cast iron main and copper services beyond 2009?

A. Yes. Subject to receiving approval of its Rider QIP, the Company is proposing to continue its accelerated replacement of these facilities so that all cast iron main and

copper services would be replaced within ten years. To achieve this goal, the Company would need to continue the program beyond 2009 and replace approximately 40 miles of cast iron main and 9,000 copper services per year, which is an increase over the average annual rate from the period 2005-2007 of about 25 miles of cast iron main and 5,500 copper services.

Q. What financial impediments does the Company face by accelerating the current replacement program under its existing rate design?

A. The replacement of cast iron main and copper services is not a revenue-generating activity for Nicor Gas because it does not result in the addition of any new customers or volumes. Presently, the Company does not earn a return on or of the capital it invests in replacing cast iron main and copper services between rate cases. As such, the Company has an economic disincentive under current rate design to make accelerated yearly capital investments because its ability to earn a return on and of these additional investments will be delayed until the conclusion of a future rate case.

Q. How does Rider QIP address recovery of accelerated capital investments?

A. Rider QIP would allow the Company the opportunity to begin to recover the return on and of the increased amounts of its annual capital investment under an accelerated replacement program as those investments are made rather than delaying recovery to the next rate case. To be clear, Rider QIP would only apply to capital investments associated with annual replacement of cast iron main and copper services in excess of the annual baseline amounts that would have been expected to be replaced if the program were not accelerated.

Q. When developing Rider QIP, what did Nicor Gas consider?

A. In designing Rider QIP, Nicor Gas considered the Commission's guidance in its final order in the Peoples Rate Case relating to the proposed infrastructure replacement rider. The Company also considered requirements set forth for infrastructure plant surcharges in Section 9-220.2 of the Public Utilities Act (the "Act") and Part 656 of the Commission's rules. 220 ILCS 5/9-220.2; 83 Ill. Adm. Code Part 656. Specifically, in response to the Commission's guidance in the Peoples Rate Case, Nicor Gas has identified and quantified reduced system costs. (*See* Peoples Rate Case Order at 162). Nicor Gas also considered the following guidance from the Commission regarding the criteria for any rider proposal seeking to recover certain costs associated with such capital investments outside of a rate case:

> We believe that a Rider scripted in accordance with the strictures of Part 656 would ensure that only the costs of the CI/DI Main Replacement Program are recovered through the rider, since the rider would have to meet specific criteria in order to be eligible. The legislature has given guidance on the appropriate methodology to be utilized when drafting a Rider for the Commission's consideration.

(*Id.* at 161) (citations omitted).

Q. In what manner was Section 9-220.2 of the Act used in developing Nicor Gas' Rider QIP?

A. Section 9-220.2 of the Act provides, in part, that the Commission may authorize a water or sewer utility to implement a surcharge to recover "costs associated with an investment in qualifying infrastructure plant, independent of any other matters related to the utility's revenue requirement". Like water and sewer utilities, Nicor Gas seeks to replace older

facilities and upgrade its system. With Rider QIP, the Company simply seeks a recovery mechanism similar to that which is available to water and sewer utilities.

Q. How did Nicor Gas consider Part 656 in developing Rider QIP?

A. Nicor Gas considered several sections of Part 656 as a guide in developing its rider design:

- **Part 656.10(b) provides for a surcharge that includes cost recovery of the return on and depreciation expense related to the utility's investment in qualified infrastructure.** Rider QIP provides for recovery on its investment and the depreciation expense. Additionally, Nicor Gas proposes a credit against the investment amount for a specified amount per mile of incremental O&M cost savings.

- **Part 656.30(a) provides that the percentage surcharge shall be capped at a percentage of the utility's base revenues.** Consistent with the cap contained in Part 656.30(a) the Company's Rider QIP limits its annual capital investment to $20 million.

- **Part 656.40 provides that project scope and cost recovery are limited to plant additions that reflect replacement of existing plant that may be worn out, deteriorated or obsolete and at the end of its useful life.** This is exactly the type of plant Nicor Gas is planning to replace and include in Rider QIP for cost recovery. Nicor Gas has not installed cast iron main for decades and no copper services have been installed in over 35 years. Replacement of these facilities at an accelerated rate is in the best interest of our customers.

- **Part 656.60(a) provides that charges be set as a "percentage" of base revenues.** Rider QIP provides for charges to be determined as a percent of base revenue.

- **Part 656.80 provides for annual reports and reconciliations.** The Company's proposed Rider QIP provides for reports and reconciliations.

Q. Does Nicor Gas expect to realize any cost savings by accelerating the rate of replacement of its cast iron main and copper services?

A. Yes. As stated in the direct testimony of Mr. McCain (Nicor Gas Ex. 5.0), Nicor Gas expects to realize a quantifiable annual reduction in O&M expense of approximately $3,200 per mile of cast iron main replaced. However, this does not take copper service replacement savings and the intangible benefits of an upgraded system into account. Based on its system maintenance experience the Company proposes to credit customers with $6,000 per mile of O&M savings for each incremental mile of cast iron main replaced under Rider QIP.

Q. If Rider QIP is approved, what does Nicor Gas propose with respect to a reduction in O&M expenses?

A. If the accelerated program can be maintained at the level the Company has set for 2008 and 2009, it would mean an annual reduction in O&M expense of approximately $150,000 per year.

Q. How generally would Rider QIP work?

A. Rider QIP sets forth a formula to determine a percentage factor that would be applied to the base revenue charges of each customer to recover the allowable costs. The mechanics of Rider QIP are described in the direct testimony of Mr. Mudra. (Nicor Gas Ex. 14.0).

Q. Does Rider QIP provide for direct incorporation of specific cost savings in its calculations?

A. Yes. The anticipated reduction in O&M expenses are deducted in determining the amount of the annual charge under Rider QIP.

Q. What benefits would the Company's customers receive from implementing Rider QIP?

A. Accelerated replacement of cast iron main and copper services will improve the efficiency and reliability of the Company's distribution system. It will reduce O&M costs and is expected also to result in a lower overall capital costs to complete the total replacement of all remaining cast iron main and copper services.

Q. How would Rider QIP impact Nicor Gas?

A. Nicor Gas would have an improved distribution system in areas that are not providing incremental base revenues to finance such improvements. Nicor Gas could replace additional pipe without the disincentive of waiting until the next rate case to get a return on and of its investment.

Q. From a policy perspective, why should the Commission approve Rider QIP?

A. While the current rate of replacement does not pose any threat to safety or reliability of service, the Company's cast iron main and copper services are old, inefficient and costly to maintain. For operational purposes, Nicor Gas would like to replace all of these remaining facilities at an accelerated pace. Accordingly, the Commission should approve Rider QIP because it will improve the efficiency and reliability of the Company's distribution system. It also will pass on reduced O&M to customers on a timely basis.

VII. CONCLUSION

Q. Does this conclude your direct testimony?

A. Yes.