

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company)
d/b/a Nicor Gas Company)
) Docket No. 08-0363
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

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TABLE OF CONTENTS

	Page
I. Introduction and Background	2
A. Witness Identification	2
B. Background and Experience	2
II. Purpose of Testimony and Summary of Conclusions.....	3
III. Riders as Cost Recovery Mechanisms	5
IV. Expense Recovery Riders (Riders UEA And CUA).....	6
A. Rider 26: Uncollectible Expense Adjustment.....	11
B. Rider 27: Company Use Gas Cost Adjustment.....	16
V. Volume Balancing Adjustment and Energy Efficiency Riders (Riders VBA and EEP)..	20
A. Rider 28: Volume Balancing Adjustment.....	22
B. Rider 29: Energy Efficiency Plan	26
VI. Capital Investment Cost Recovery Rider (Rider QIP).....	28
VII. Conclusion	34

1 **I. INTRODUCTION AND BACKGROUND**

2 **A. WITNESS IDENTIFICATION**

3 **Q. Please state your name and business address.**

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

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

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

9 **B. BACKGROUND AND EXPERIENCE**

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

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

14 **Q. Please summarize your educational background and experience.**

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

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

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

26 **Q. Have you previously testified before the Illinois Commerce Commission**
27 **(“Commission”)?**

28 A. Yes. I testified in the Company’s last rate case, Docket No. 04-0779 (“2004 Rate Case”).

29 **II. PURPOSE OF TESTIMONY AND SUMMARY OF CONCLUSIONS**

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

31 A. The purpose of my direct testimony is to identify and describe Nicor Gas’ five new
32 riders, which are being proposed in response to changing business conditions.

33 Specifically, I discuss the need for the following proposed riders:

- 34 • **Uncollectible Expense:** Rider 26, Uncollectible Expense Adjustment (“Rider
35 UEA”), provides for timely recovery of the volatile and significant cost associated
36 with bad debt;
- 37 • **Natural Gas Used by Nicor Gas:** Rider 27, Company Use Adjustment (“Rider
38 CUA”), provides for timely recovery of the volatile and significant effects of gas
39 price changes in the cost of natural gas used by the Company in the normal course
40 of its business operations;
- 41 • **Volume Balancing Adjustment:** Rider 28, Volume Balancing Adjustment
42 (“Rider VBA”), provides the Company the opportunity to maintain allowed
43 revenues per customer sufficient to recover its fixed costs as approved in this
44 proceeding, despite changes in customer usage from year to year;
- 45 • **Energy Efficiency Plan Expenses:** Rider 29, Energy Efficiency Plan (“Rider
46 EEP”), provides for the timely recovery of costs associated with creating and
47 implementing an energy efficiency plan; and

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

52 **Q. What is the conclusion of your direct testimony?**

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

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

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

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

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

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

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

87 **III. RIDERS AS COST RECOVERY MECHANISMS**

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

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

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

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

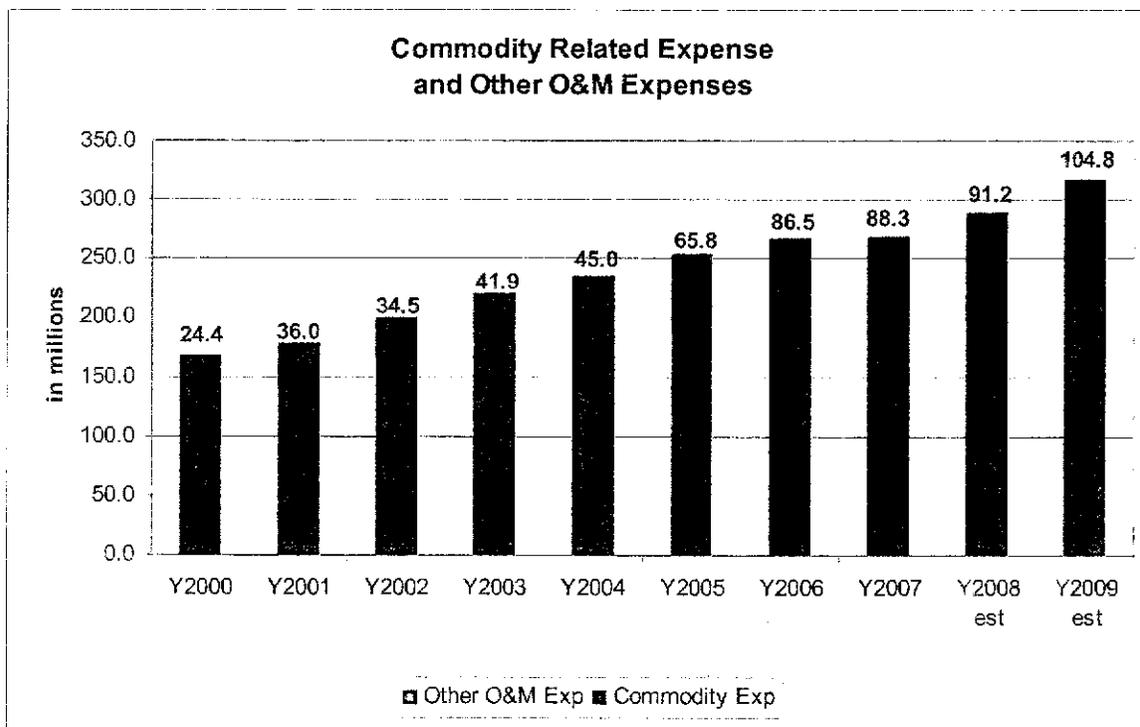
109 In sum, cost recovery riders are part of the traditional ratemaking approach that
110 has been used in Illinois, and other jurisdictions, for decades. These riders better track
111 costs with prices and provide for the timely recovery of those costs. Volume balancing
112 adjustment riders serve an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

116 **IV. EXPENSE RECOVERY RIDERS (RIDERS UEA AND CUA)**

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

118 A. Natural gas prices are the most important factor affecting the Company's expenses.
119 Natural gas prices are very volatile when compared to other operating and maintenance
120 ("O&M") expenses and have become a much larger percentage of Nicor Gas' total O&M
121 expenses recovered through base rates. As depicted in Figure 1 below, the annualized
122 increase in natural gas-related O&M expenses during the period 2000 to 2009 was
123 17.6%, compared to 4.5% for other O&M expenses during that same period.

124 FIGURE 1.



125

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

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

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

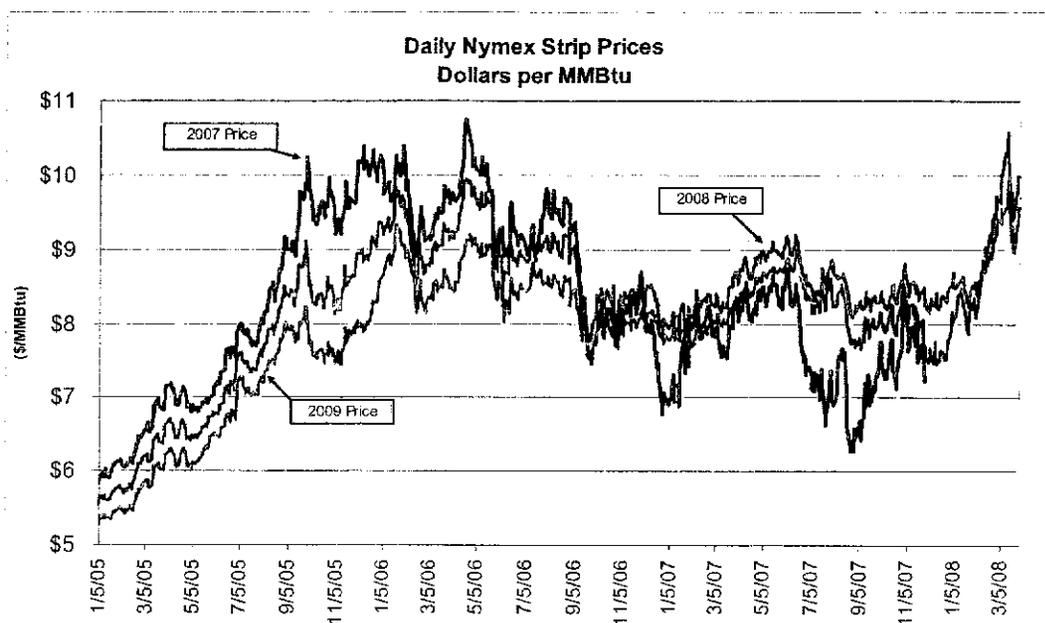
133 **Q. How do gas price fluctuations affect the cost of gas used in Company facilities?**

134 A. There is a direct dollar-for-dollar relationship. For each \$1.00 per MMBtu increase or
135 decrease in the price of gas, there will be a corresponding increase or decrease of a \$1.00
136 per MMBtu in the cost for Company Use gas. Nicor Gas purchases approximately
137 3,100,000 MMBtu of gas for Company Use annually. Accordingly, a \$1.00 per MMBtu
138 price change would equate to an increase or decrease of \$3.1 million in Company Use
139 expense. Given recent historical trading ranges for natural gas, gas price movements
140 greater than \$1.00 per MMBtu can be expected.

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

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

FIGURE 2:



146

147 **Q.** Could you please explain what Figure 2 shows?

148 **A.** Figure 2 demonstrates the volatility of natural gas prices. The graph plots the average of
 149 Nymex closing prices of natural gas for delivery in future years (2007 – 2009) or
 150 remainders of years (2007 – 2008), as settled daily from January 2005 through the
 151 beginning of April 2008. The range of volatility in natural gas prices is clearly depicted.
 152 For example, as shown by the 2007 Futures line, the average of the 2007 Nymex Futures
 153 contracts rose from a low of under \$6 per MMBtu in January 2005 to almost \$11 per
 154 MMBtu in April 2006. Similarly, the average of the 2009 Nymex Futures contracts rose
 155 from approximately \$5.20 per MMBtu in January 2005 to a high of almost \$10 in March
 156 2008.

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

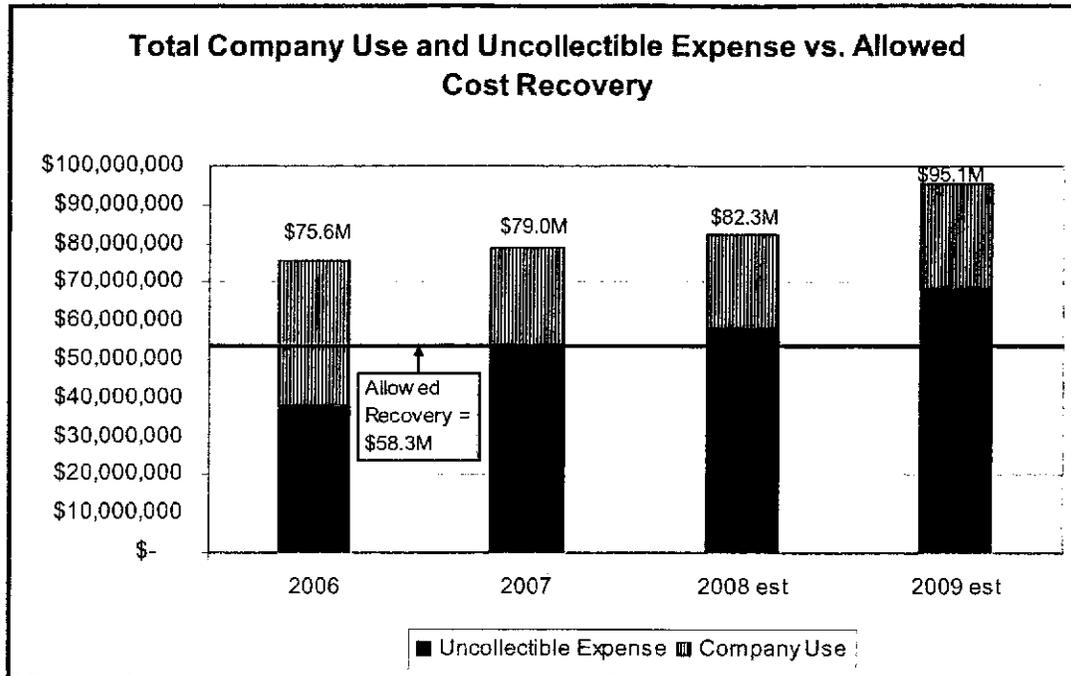
160 **Q. How do gas price fluctuations impact Uncollectible Expense?**

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

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

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

FIGURE 3



171

172 **Q. Please describe what is shown in Figure 3.**

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

179 **A. RIDER 26: UNCOLLECTIBLE EXPENSE ADJUSTMENT**

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

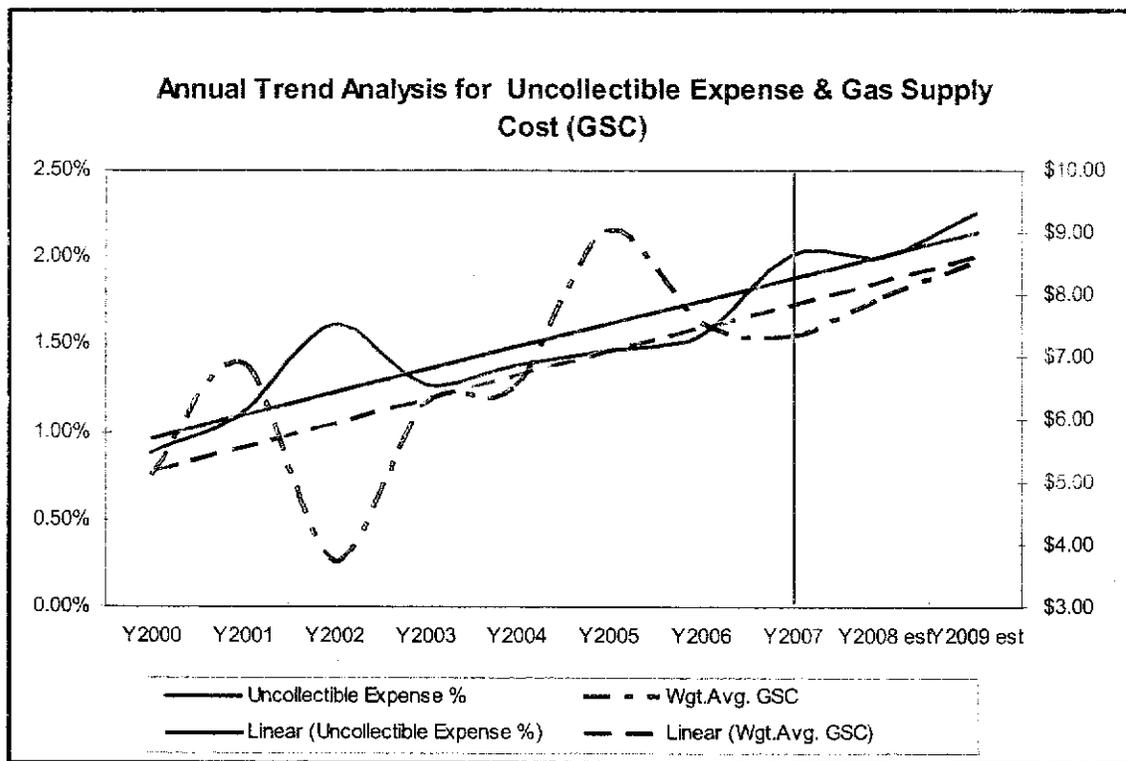
181 A. Rider UEA addresses the impact volatile gas prices have on Uncollectible Expense. The
 182 costs that comprise Uncollectible Expense are closely correlated to natural gas prices,

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

186 **Q. Please explain what is shown on Figure 4.**

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

192 **FIGURE 4**



193

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

195 A. As discussed in the direct testimony of Nicor Gas witnesses Kevin W. Kirby and James
196 M. Gorenz (Nicor Gas Exs. 6.0 and 11.0, respectively), Uncollectible Expense has
197 become a significant portion of Nicor Gas' operating expenses, rising from a level of
198 approximately \$38.5 million approved in the 2004 Rate Case to \$53 million in 2007, and
199 to approximately \$68.3 million projected in the test year. Not only has the dollar level of
200 Uncollectible Expense risen, but the rate at which revenue billed becomes uncollectible
201 also has risen, from the 1.40% applied in the 2004 Rate Case to 2.02% in 2007, and to
202 2.25% projected in the 2009 test year.

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

204 A. Annually, Nicor Gas would compare the amount of authorized Uncollectible Expense
205 provided for in its base rates with its actual expense. Rider UEA would use the amount
206 of Uncollectible Expense approved by the Commission in this proceeding as a base
207 starting point. Nicor Gas proposes a plus or minus 5% dead-band around the authorized
208 amount. If the actual amount of Uncollectible Expense falls within the dead-band, there
209 would be no adjustment. If actual expenses exceed the base amount by more than 5%,
210 the amount in excess of the dead-band would be collected from ratepayers from April
211 through December of the following year. Likewise, if actual expenses are lower than
212 95% of the base amount, the amount outside the dead-band would be returned to
213 ratepayers. Mr. Mudra discusses the mechanics of Rider UEA in his testimony. (Nicor
214 Gas Ex. 14.0).

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

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

225 **Q. What benefits would Rider UEA provide to ratepayers?**

226 A. Rider UEA would reduce customer charges in the event the costs that comprise
227 Uncollectible Expense are reduced beyond the band width of the rider. As previously
228 discussed, the Uncollectible Expense amount approved in the 2004 Rate Case was
229 \$38.5 million. If the Company's actual Uncollectible Expense costs were again to
230 decline to that level in a subsequent year, customers would be entitled to receive a credit
231 of nearly \$29.5 million under Rider UEA. Without Rider UEA, customers would not
232 receive any refund based upon this reduced cost. Given the volatility of natural gas
233 prices, it is certainly conceivable that the Company's Uncollectible Expense could
234 decline significantly from its forecasted test year amount in one year, only to climb again
235 to a level at or above the forecasted test year amount in subsequent years. As such, there
236 is no guarantee that a reduction in Uncollectible Expense realized in one year will have
237 any impact on the level of Uncollectible Expense approved for the Company in a
238 subsequent rate case.

239 **Q. How would Rider UEA impact Nicor Gas?**

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

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

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

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

262 **B. RIDER 27: COMPANY USE GAS COST ADJUSTMENT**

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

265 A. Nicor Gas is proposing Rider CUA.

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

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

274 **Q. Please explain the purpose of Rider CUA.**

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

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

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

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

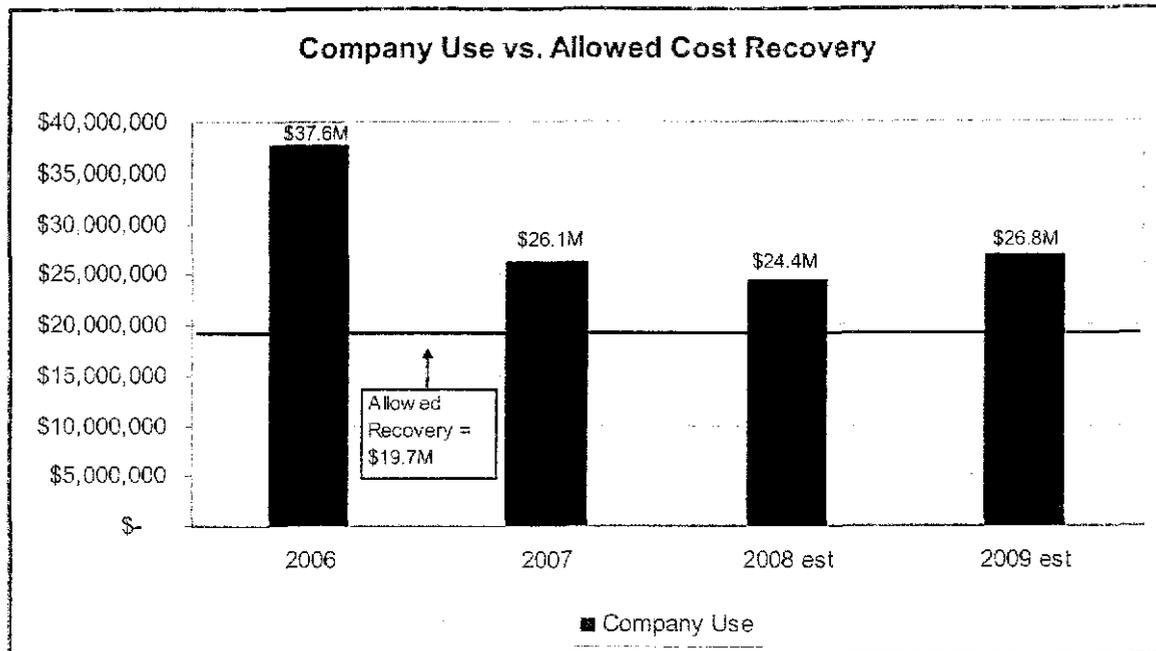
288 **Q. Would Rider CUA remove an incentive for Nicor Gas to manage Company Use**
289 **costs effectively?**

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

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

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

FIGURE 5



305

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

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

312 Q. What benefits would Rider CUA provide to ratepayers?

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

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

322 **Q. How would Rider CUA impact Nicor Gas?**

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

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

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

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

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

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

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

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

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

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

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

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

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

376 **Q. Is this situation unique to Nicor Gas?**

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

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

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

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

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

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

393 **A. RIDER 28: VOLUME BALANCING ADJUSTMENT**

394 **Q. Has the Commission approved a volume balancing adjustment mechanism like**
395 **Nicor Gas’ proposed Rider VBA?**

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

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

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

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

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

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

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

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

428 Q. **What benefits would ratepayers receive from Rider VBA?**

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

438 Q. **How does Rider VBA impact Nicor Gas?**

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

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

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

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

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

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

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

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

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

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

475 **B. RIDER 29: ENERGY EFFICIENCY PLAN**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

534 **VI. CAPITAL INVESTMENT COST RECOVERY RIDER (RIDER QIP)**

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

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

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

545 A. As discussed more fully in the direct testimony of Nicor Gas witness Anthony R. McCain
546 (Nicor Gas Ex. 5.0), the Company has utilized a risk-based approach to prioritize the
547 replacement of its cast iron main and copper services. This has resulted in the
548 replacement, on average, of approximately 15 miles of cast iron main and 3,500 copper
549 services per year for the period from 2005 through 2007. At those replacement rates, the
550 process to replace all cast iron main and copper services would take approximately 32
551 years to complete. The Company budgeted for and initiated an accelerated program for
552 2008 and 2009, under which approximately 40 miles of cast iron main and 9,000 copper
553 services will be replaced each year. However, the Company cannot maintain this
554 accelerated rate of replacement without a mechanism to ensure timely recovery of the
555 incremental capital investments.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

618 • **Part 656.30(a) provides that the percentage surcharge shall be capped at a**
619 **percentage of the utility's base revenues.** Consistent with the cap contained in
620 Part 656.30(a) the Company's Rider QIP limits its annual capital investment to
621 \$20 million.



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

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

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

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

636 A. Yes. As stated in the direct testimony of Mr. McCain (Nicor Gas Ex. 5.0), Nicor Gas
637 expects to realize a quantifiable annual reduction in O&M expense of approximately
638 \$3,200 per mile of cast iron main replaced. However, this does not take copper service
639 replacement savings and the intangible benefits of an upgraded system into account.
640 Based on its system maintenance experience the Company proposes to credit customers
641 with \$6,000 per mile of O&M savings for each incremental mile of cast iron main
642 replaced under Rider QIP.

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

645 A. If the accelerated program can be maintained at the level the Company has set for 2008
646 and 2009, it would mean an annual reduction in O&M expense of approximately
647 \$150,000 per year.

648 **Q. How generally would Rider QIP work?**

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

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

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

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

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

662 **Q. How would Rider QIP impact Nicor Gas?**

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

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

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

674 **VII. CONCLUSION**

675 **Q. Does this conclude your direct testimony?**

676 A. Yes.

STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company)
d/b/a Nicor Gas Company)
) Docket No. 08-0363
Proposed general increase in rates, and)
revisions to other terms and conditions)
of service)

AFFIDAVIT

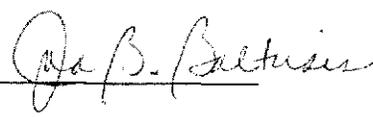
I, Gerald P. O'Connor, under oath, hereby swear to the following:

1. I am the Senior Vice President Finance and Strategic Planning of Nicor Gas Company;
2. I prepared prefiled Direct Testimony on behalf of Northern Illinois Gas Company, d/b/a Nicor Gas Company, submitted as Nicor Gas Ex. 12.0, and filed on April 29, 2008;
3. The answers set forth in my Direct Testimony are to the best of my knowledge, true and correct; and
4. If asked those same questions today, my answers would be the same.



Gerald P. O'Connor

Subscribed and sworn to before me
this 6th day of November, 2008.



Notary Public

