STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

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

REPLY BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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NOW come the Staff witnesses of the Illinois Commerce Commission ("Staff"), by and through their undersigned counsel, pursuant to Section 200.800 of the Illinois Commerce Commission's Rules of Practice (83 Ill. Adm. Code 200.800), and respectfully submit their Reply Brief in the instant proceeding.

Staff's Initial Brief identified and responded to many of the arguments raised in the Initial Briefs filed by the different parties. In this Reply Brief, Staff responds only to the extent that the Company or other parties raised arguments that Staff did not adequately address in its Initial Brief. Staff has not altered its positions and arguments set forth in its Initial Brief and those arguments are incorporated and adopted as if fully set forth herein.

I. Introduction/Statement of the Case

On April 29, 2008, Northern Illinois Gas Company d/b/a Nicor Gas Company ("Nicor Gas" or "Company") filed with the Illinois Commerce Commission ("Commission") revised tariff sheets in which it proposed a general increase in gas rates pursuant to Article IX of the Illinois Public Utilities Act ("Act" or "PUA"), 220 ILCS 5/9, to become effective June 13, 2008. On June 4, 2008, the Commission suspended the filing to and including September 25, 2008, for a hearing on the proposed rate increase.

On September 10, 2008, the Commission re-suspended the tariffs to and including March 25, 2009.

The following Staff Witnesses have submitted testimony in this case: Dan Kahle (Staff Exs. 1.0 and 14.0), Dianna Hathhorn (Staff Exs. 2.0 and 15.0), Burma Jones (Staff Exs. 3.0 and 16.0), Mike Ostrander (Staff Exs. 4.0R and 17.0), Janis Freetly (Staff Exs. 5.0 and 18.0C), Sheena Kight-Garlisch (Staff Exs. 6.0C and 19.0C), Peter Lazare (Staff Exs. 7.0 and 20.0), Christopher Boggs (Staff Exs. 8.0 and 21.0), Dennis Anderson (Staff Exs. 9.0 and 22.0 (Public & Confidential)), Mark Maple (Staff Exs. 10.0 and 23.0), David Sackett (Staff Exs. 11.0R and 24.0R2), Bill Voss (Staff Ex. 12.0), and David Brightwell (Staff Exs. 13.0 and 25.0).

The following parties have also submitted testimony in this case: People of the State of Illinois and the Citizens Utility Board ("AG/CUB"), Environmental Law and Police Center ("ELPC"), Vanguard Energy Services LLP ("VES"), Constellation New Energy-Gas Division LLC ("CNE"), Interstate Gas Supply of Illinois Inc. ("IGS"), Illinois Industrial Energy Consumers ("IIEG"), Coalition for Equal Access and Fair Utility Practice ("CEAFUR"), and Customer Select Gas Suppliers ("CSGS"). The following parties have also submitted Initial Briefs in this case: IIEG, CNE, CSGS, VES, CUB, AG, and ELPC.

II. Overall Revenue Requirement and Revenue Deficiency

As reflected on page 1, line 5, column (i) of Appendix A to Staff's Initial Brief, Staff recommends revenues of $631,078,000. This is an increase of $63,494,000 or 11.19%, to Nicor Gas' pro forma present revenues of $567,584,000 as shown in Appendix A, page 1, line 5, column (d). This revenue increase is calculated at line 26, column (i) of page 1 of Appendix A.

III. Test Year

IV. Rate Base

A. Overview

B. Uncontested Issues

1. Northern Region Reporting Center (“NRRC”)

2. Plant Additions – Original Cost Finding

C. Contested Issues

1. Cash Working Capital

Staff maintains its proposal to reduce the amount of Cash Working Capital (“CWC”) added to rate base for pass-through taxes because pass-through taxes represent funds provided by ratepayers rather than investors.

The Commission should adopt revenue lag days of zero for pass-through taxes and reject the Company’s arguments that pass-through taxes represent operating revenue to the Company. The Commission should not allow the Company to increase its rate base for revenue lag on funds for pass-through taxes because funds for pass-through taxes are provided by ratepayers. Ratepayers should not be forced to pay a return to investors on funds that the ratepayers themselves have provided.

Staff takes exception to several of the positions put forth in the Company’s Initial Brief.

Additional Analysis

The Company wishes the Commission to focus on two previous Dockets where the Company’s methodology for determining the CWC requirement was approved. (Co. IB, p. 11) The Commission should not limit its consideration of this issue to those prior dockets for two reasons. First, a decision in a previous rate case is no reason to ignore the facts in this proceeding, and there is no reason to assume that this Company operates in the same manner as any other utility. (Staff Ex. 14.0, p. 10) Second, in this proceeding, Staff provided additional analysis of the issue as the Commission requested in its Final Order in Docket No. 07-0241/07-0242 (cons.). (See Co. IB, pp. 13-14) The Company mistakenly asserts that Staff did not provide new or unique information in this proceeding. (*Id*.) The Company's assertion is incorrect. Staff did present analyses that were not offered in the previous dockets. (Staff Ex. 1.0, pp. 9-11 and Staff Ex. 14.0, pp. 6-7) As thoroughly discussed in Staff's Initial Brief (Staff IB, pp. 4-9), in this proceeding, Mr. Kahle presented an analysis of the collection and remittance of pass-through taxes which was not available for the Commission to consider in the previous dockets discussed by Mr. Adams. (Staff Ex. 1.0, pp. 9-11 and Staff Ex. 14.0, pp. 6-9) Mr. Kahle clearly demonstrates, through the Company's responses to data requests, that the Company does indeed receive pass-through taxes from ratepayers, hold those funds, and later remit those funds to the taxing authorities.

Pass-Through Taxes Are Not Part of Utility Operations

The Company's own presentation of its proposed revenue requirement, i.e., the fact that pass-through taxes are not included in the revenue requirement, demonstrates that Staff's position is the correct one. Staff agrees with the Company's definition of CWC as the amount of funds required to finance the day-to-day operations of the Company and that a lead-lag study measures the timing differences between the receipt of funds from the utility's customers for services provided and the payment for goods and services received by the Company. (Co. IB, p. 11) Using this definition, the Company correctly removed pass-through taxes from the revenue requirement. By removing pass-through taxes from the revenue requirement, the Company itself demonstrates that pass-through taxes are not related to its operations, i.e., the delivery of gas. The revenue requirement determines the total operating revenue the Company is authorized an opportunity to recover, which includes operating expenses and a reasonable return on rate base: there is no allowance for pass-through taxes.

The Company offers another argument for considering pass-through taxes to be operating revenue by pointing out that pass-through taxes are collected through the same mechanism as operating revenue from gas sales. The Company's logic is that since it uses ratepayers' bills as the mechanism to collect pass-through taxes, pass-through taxes should be treated the same as operating revenue from gas sales in the CWC calculation. (Co. IB, p. 13) The Company errs here by putting form ahead of substance. The form of the collection of pass-through taxes does not change their substance. Pass-through taxes are ratepayers' taxes which will pass-through the Company to taxing authorities; adding pass-through taxes on to the ratepayers' bills does not change them into operating revenue.

The Company then attempts to use its internal accounting for pass-through taxes as a justification for treating pass-through taxes the same as operating revenue in the CWC calculation. (Co. IB, p. 14) However, the Company does not say why its internal procedures should take priority over the ratemaking process. As stated above, the Company removed pass-through taxes from its revenue requirement.

The Company next argues that pass-through taxes are operating revenue because of a relation to the consumption of natural gas. (Co. IB, p. 15) While the Company must incur operating expenses to provide natural gas service, the existence or absence of pass-through taxes does not affect the delivery of natural gas services. While the pass-through taxes may be calculated based on the amount or value of natural gas consumed, pass-through taxes could, in theory, be collected by taxing authorities in some other manner without affecting the Company's operating revenue or expenses. (Staff Ex. 14.0, p. 5)

Finally, the Company claims that pass-through taxes are operating revenue because Nicor Gas is required to be the conduit between the ratepayer and the taxing authorities. (Co. IB, p. 15) This argument is irrelevant as the method by which ratepayers pay pass-through taxes to the taxing authorities does not change the substance of the matter.

No Pass-through Tax Recovery

The Company also makes a rather curious claim that it is allowed to recover the Illinois Public Utility Tax, the Illinois Gas Revenue Tax and municipal gas receipts taxes from customers through the ratemaking process, similar to any other expense. (Co. IB, p. 15) The Company makes this claim in spite of having removed these pass-through taxes from its revenue requirement by making an adjustment in its Summary of Utility Proposed Adjustments to Operating Income - Schedule C-2. This adjustment is detailed in the Company's schedule of Add-on Taxes - Schedule C-25. Both schedules were included in the Company's initial filing.

Balance

Finally, the Company introduces a novel principle it calls "Balancing of Revenue and Expenses" reflected in the CWC analysis. (Co. IB, p. 12, 16) The Company clings to this position even though Company witness Adams states that he has no authoritative pronouncement to support that position (Co. Ex. 42.0, p. 10) In fact, CWC determinations made by the Commission in two of the most recent three rate cases have been based on analyses in which revenue and expenses were not equal. (Staff Ex. 14.0, pp. 11-12) Notwithstanding, in the current docket, cash payments exceed receipts in Staff's CWC calculation by only 0.01% (($2,810,695 - $2,810,315) / $2,810,695). (Staff IB, App. A, p. 10)

The Company is wrong when it claims that Staff does not include sufficient cash receipts for payment of all expenses and that Staff's analysis reflects payments for which there are no corresponding cash receipts. (Co. IB, pp. 16-17) Staff's analysis does include sufficient cash receipts for payment of all expenses since cash payments exceed receipts by only one-hundredth of one percent. Staff's analysis merely uses two different measures of lag days for two different types of cash receipts. This treatment for different types of cash receipts is the same as using different measures of lead days for different types of expenses. For example, using different lag days for pass-through taxes and operating revenues is no different than using different lead days for Employee Benefits and Payroll and Withholdings expenses. (Staff IB, App. A, p. 10)

Staff also notes the AG's support for Staff's proposed adjustment to CWC. (AG IB, p. 9)

2. Gas in Storage

3. Pension Asset

The Company maintains that it prepared and presented its case in a straightforward manner, and wherever possible, looked to prior Commission Orders for guidance. (Co. IB, p. 3) It also expresses concern that several of Staff's and/or the AG/CUB's "most significant proposed adjustments to Nicor Gas' revenue requirement directly contradict prior Commission Orders, including the 2004 Rate Case Order." (*Id*., p. 4) Yet, despite two prior Nicor Gas Commission Orders that rejected the Company's pension asset position presented in this case and not a single change in facts, the Company continues to maintain that its position on pension asset should be allowed in rate base. (*Id*., p. 20; Staff IB, pp. 9-10) Nicor Gas continues to incorrectly assert that the pension asset investments were made by the Company. (Co. IB, p. 20) Staff has demonstrated otherwise, and the two prior Nicor Gas Commission orders affirm Staff's conclusion. (Staff IB, pp. 10-13) Accordingly, the Commission should adopt Staff's and the AG/CUB's adjustments to disallow the pension asset from rate base.

4. Gross Plant

Staff witness Ostrander proposed an adjustment to reduce the Company's 2008 and 2009 estimated plant additions by 2.87% based upon the average historical variance between budgeted plant additions and actual plant additions. (Staff Ex. 4.0R, Sch. 4.02 and Staff Ex. 17.0, Sch. 17.02) In Nicor Gas' Initial Brief, the Company has repeated its same arguments made in testimony against Mr. Ostrander's adjustment to the Company's 2008 and 2009 estimated plant additions. (Co. IB, pp. 21-22) Staff has already addressed the Company's arguments in its Initial Brief and will not repeat that full discussion here. (Staff IB, pp. 14-17) Essentially, the Company continues to argue that historically, the Company's capital expenditures budgets have been remarkably accurate and that Staff's adjustment analysis is skewed due to not using the same type of data for each year of the proposed adjustment period.

As Staff witness Ostrander pointed out, the facts show that the Commission found that an under budget variance of 0.8% in the Company's last rate case was not accurate enough. The Company's claim that Staff used an incorrect budget amount for 2004 also contradicts the facts in evidence. The 2004 budget amount relied upon to develop Staff's proposed adjustment of 2.87% is the same amount the Company provided in response to Staff's oral data request and relied upon by Staff and the Commission to make a plant adjustment in the Company's last rate case.

In its Initial Brief, the Company also notes that actual plant additions year to date through October 2008 were over budget and argues that this negates the need for Staff's proposed adjustment. (Co. IB, p. 22) However, the facts in the record also indicate that the actual plant additions year to date through September 2008 were under budget. This month-to month fluctuation demonstrates that budgeted plant additions are not a sufficiently accurate indicator of actual plant additions and actually further supports the need for Mr. Ostrander's proposed adjustment.

5. Accumulated Reserve for Depreciation and Amortization
6. Incentive Compensation
7. Other

V. Operating Expenses

A. Overview

B. Uncontested Issues

1. Incentive Compensation
2. Pension Credit
3. Environmental Expenditures
4. Invested Capital Taxes
5. Promotional Expenses
6. Training / Seminar Expenses / Economic
7. Membership Dues
8. Certain Charitable Expenses
9. Taxes Other Than Income Taxes

C. Contested Issues

1. Incentive Compensation Costs and Expenses

The Company does not assert that the cost of its Incentive Compensation Unit ("ICU") Plan will provide benefits to ratepayers, or that the ICU Plan "conform[s] entirely with the Commission's current view of incentive compensation plans." Rather, it asserts ratepayers should have to bear this $325,000 cost because they have been paying this cost "for decades." (Co. IB, pp. 29-30) However, since this specific ICU Plan has never come before the Commission as a contested issue (Staff IB, p. 26), Nicor Gas' reliance on prior orders is misplaced.

Nicor Gas also attempts to re-define the ICU Plan cost as non-financially driven since an employee's eligibility for the ICU Plan—determined back in 1968 to 1980 when the plan was in effect—was not based solely on financial results at that time. (Co. IB, pp. 29-30) Staff has demonstrated, however, that the test year ICU Plan expense is calculated solely upon the net increase in earnings per share (Staff IB, p. 22), and therefore meets the Commission's consistent criteria for disallowing incentive compensation costs based on financially driven results benefitting shareholders. (*Id*. pp 22-26) The AG and CUB both support Staff's adjustment. (AG IB, p. 14; CUB IB, pp. 7-8) Staff's adjustment is soundly based upon the evidence of this case and well-established Commission criteria for incentive compensation expense, and should be adopted by the Commission.

CUB also recommends disallowing $2,276,000 in incentive compensation allocated to the Company from Nicor, Inc. (CUB IB, pp. 8-9) However, the Company has already agreed to Staff's adjustment in direct testimony to remove these costs from the test year. (Staff IB, p. 18; Co. IB, p. 25) The Company's acceptance of the adjustment is reflected in Staff's rebuttal position and in Appendix A to Staff's Initial Brief; therefore, no additional adjustment for incentive compensation costs allocated by Nicor, Inc. is necessary.

2. Uncollectible Accounts Expense

The Company contends that its proposed uncollectibles rate should be adopted since Staff's and AG/CUB's proposals fail to consider the Company's history in forecasting uncollectibles expense, and deny the upward trend in its expense. (Co. IB,

p. 32) The Company goes on to fault Staff and the AG/CUB for not providing evidence to refute the upward charge off trend. (*Id*., p. 34) However, Staff's recommended rate of 2.02% undeniably recognizes that an increase to the previously approved Commission rate of 1.4% is proper. (Staff IB, p. 27) Staff's proposal also weighs heavily on the Company's forecasting of uncollectibles expense, using the most recently available data from Nicor Gas as a basis for Staff's recommendation. (*Id*.) Therefore, the Company's criticism of Staff's proposal on these points is misplaced.

The Company further supports its proposed rate by stating that all indications are that the trend will only worsen, and the Commission should not blind itself to current economic reality. (Co. IB, p. 33) However, the 2008 budgeted charge offs which Staff recommends includes a 33% contingency factor increase to account for the impact of the weakened economy and higher cost of natural gas. The Company has not demonstrated why the 2009 budgeted charge offs should be increased another 25% for these same contingency factors. (Staff IB, p. 27) The Company has not proven why such a large contingency factor is reasonable. Staff's proposal considers the Company's most recent forecast data which incorporates a contingency factor for the weakened economy, and provides a commensurate increase in the Company's currently authorized rate. Accordingly, Staff's proposal is the most reasonable alternative on this issue and should be adopted by the Commission.

3. Rate Case Expense

At issue is the length of the amortization period for the rate case expense. The Company proposes a three-year amortization period, while Staff proposes a four-year amortization period based upon the length of the Company's proposed pilot program for Rider VBA. The Company argues that Staff's proposal is inconsistent because Staff has simultaneously recommended rejecting Rider VBA. (Co. IB, p. 36) This argument has no merit as Staff has not recommended that the Commission reject Rider VBA. (Staff IB, pp. 154-155) A four-year amortization period is more reasonable than the three-year amortization period proposed by the Company and should be adopted by the Commission. (Staff IB, pp. 28-30)

4. Payroll / Headcount

5. Mains and Services Expenses

6. Customer Records and Collection Expenses

Staff maintains its position that, with the analysis provided by the Company, the adjustment to Customer Records & Collection Expenses proposed by AG witness Effron is not necessary.

7. Charitable Contributions

(a) Aurora Foundation

The Company's statement that the donation to the Aurora Foundation is "squarely within the provisions of Section 9-227 of the Act, which authorizes the Commission to consider donations for such a purpose as a recoverable operating expense, and prohibits the Commission from disallowing such donations by rule" is misleading. (Co. IB, pp. 41-42) Section 9-227 of the Act states:

> **It shall be proper for the Commission to consider as an operating expense**, for the purpose of determining whether a rate or other charge or classification is sufficient, **donations made by a public utility for the public welfare or for charitable scientific, religious or educational purposes, provided that such donations are reasonable in amount**. In determining the reasonableness of such donations, the Commission may not establish, by rule, a presumption that any particular portion of an otherwise reasonable amount may not be considered as an operating expense. The Commission shall be prohibited from disallowing by rule, as an operating expense, any portion of

> a reasonable donation for public welfare or charitable purposes. (**emphasis added**)

As explained more fully in Staff's Initial Brief, the scholarships funded by the donation to the Aurora Foundation are available only to students who have a parent employed by Nicor Gas. The money given for the scholarships is clearly not for the public welfare or for charitable purposes, as provided for recovery under Section 9-227 of the PUA. (Staff IB, p. 31) The Company cannot claim that the scholarships provided to students of Nicor Gas employees are charitable because the scholarships are not necessarily based on financial need. The donation to the Aurora Foundation also funds merit scholarships based on academic ability without consideration of financial need. (Staff Ex. 3.0, pp. 6-7) Thus, the scholarships provided by the Aurora Foundation do not necessarily benefit the neediest of Nicor Gas' employees.

The Company insinuates that the donations to the Aurora Foundation are for educational purposes and should be allowed recovery under Section 9-227. (Co. IB, pp. 41-42) However, Staff would expect that any donation recovered from ratepayers should benefit the public at large. Staff maintains that the scholarships constitute a component of the Company's overall efforts to attract and retain a qualified workforce. (Staff IB, pp. pp. 31-32) Thus, the donation that funds the scholarships is not charitable but self-serving, and it should not be recovered from ratepayers.

(b) Salvation Army – Chicago

Nicor Gas and Staff continue to disagree on whether shareholders or ratepayers should be responsible for the matching contribution to the Nicor Gas Sharing Program ("Sharing Program"), which is administered by the Salvation Army and funded by direct contributions from Nicor Gas' customers and employees. The Company appears to have arrived at the conclusion that Staff's position that ratepayers would pay twice for their generosity to the Sharing Program, once through direct contributions and again through base rates, is one of fairness to the ratepayers, but it questions whether ratepayers would claim unfairness. (Co. IB, pp. 42-43) Nicor Gas suggests that customers are motivated by the ease of donation and the dollar-for-dollar matching aspect of the Sharing Program (presumably, regardless of who provides the matching dollar). (*Id*.) However, the Company does not provide any evidence to support such a claim.

The Company's observation that major utilities that have had rate cases in recent months had no proposed adjustments to their add-a-dollar programs (*Id*.) is irrelevant, as every rate case stands on its own merits. Nothing prohibits the Commission from consideration of an issue that was not brought forth for consideration in another proceeding. Neither does the failure of Staff or a party to raise an issue in a proceeding act as a bar to the issue being raised in the future in another proceeding. (Staff Ex. 16.0, p. 9) This is especially true when there are yet other proceedings where the Commission has made findings about matching contributions. The Commission excluded matching contributions, which should be paid by shareholders, from operating expenses in Docket No. 93-0183 (Illinois Power Company) and Docket No. 95-0076 (Illinois-American Water Company). (Staff Ex. 3.0, pp. 8-9)

Staff continues to recommend that the Commission adopt its adjustment to disallow matching contributions from inclusion in operating expenses in the instant proceeding, as discussed in Staff's Initial Brief, pages 32-33.

8. Depreciation and Amortization Expenses

9. Income Taxes

10. Interest Synchronization

VI. Rate of Return

A. Uncontested Issues

1. Embedded Cost of Long Term Debt

2. Embedded Cost of Preferred Stock

B. Contested

1. Capital Structure (inclusion of short-term debt)

Lacking a sufficient substantial basis for its position that short-term debt should not be included in its capital structure, the Company attempts to divert the Commission's attention from the real issue by mislabeling Staff's proposed capital structure as hypothetical and imputed. (Co. IB, pp. 46-47) In testimony the Company did not even attempt to controvert, Staff witness Freetly stated that "impute" - in the context of capital structure - means to assign, specifically, assigning a hypothetical capital structure to Nicor Gas. Capital structures could be imputed for different reasons: (1) the utility does not have its own capital structure (e.g., the utility is a division of a larger company); (2) affiliates hold all the utility's capital, which makes distinctions between debt and equity financially meaningless; (3) the capital structure is unreasonably expensive; or (4) the capital structure does not meet other legal requirements. (Staff Ex. 18.0C, pp. 10-11)

Staff did not assign a hypothetical capital structure to Nicor Gas. Staff did not increase any of the components of Nicor Gas' capital structure above its own forecast on the grounds that Nicor Gas should increase its use of a particular component. Staff did not decrease any of the components of Nicor Gas' capital structure below its own forecast on the grounds that Nicor Gas should decrease its use of a particular component. To the contrary, Staff did not alter any of the components of Nicor Gas' own capital structure forecast. One could validly argue that the Company's proposed capital structure is imputed since it fails to include short-term debt that the Company relies on to meet the capital funding levels needed to support the seasonal increases in its rate base. As Ms. Freetly testified, whether a proposal to include the Company's own forecast of its balance of short-term debt, or alternatively, to exclude the Company's own forecast of its balance of short-term debt results in an "imputed" capital structure is an unnecessary distraction from the core issue: whether the Company uses the proceeds from its issuances of short-term debt to support the seasonal increases in its rate base. (Staff Ex. 18.0C, pp. 10-11)

a. Inclusion of Short-Term Debt

Nicor Gas shows that the Company's use of short-term debt is temporary and seasonal since the Company has no short-term debt outstanding for "several" months each year.[1] The Company claims this is sufficient evidence that it does not use short-term debt to finance rate base assets. (Co. IB, pp. 48-49) The Company's premise that short-term debt should be excluded from a utility's capital structure whenever some of its monthly short-term debt balances are zero is invalid. To the contrary, the fact that there is no outstanding short-term debt balance for three months of the year is not sufficient reason to exclude short-term debt from the Company's capital structure. In Docket No. 95-0076, an Illinois-American Water Company ("IAWC") rate proceeding, IAWC made the same argument and the Commission rejected it and concluded that short-term debt should be included in the capital structure even though IAWC projected zero balances of short-term debt outstanding for three months out of the test year. (Order Docket No. 95-0076, Dec. 20, 1995, pp. 49 & 51)

[1] Given that the Company forecasts its balance of short-term debt will equal zero for only three of twelve months during 2009 (Staff Ex, 5.0, Schedule 5.4), the Company's expansive definition of "several" accommodates values as low as "3."

Nicor Gas claims that in order for the Company to prove that short-term debt is not funding rate base, the Company must prove the negative, which is impossible. (Co. IB, p. 52) Staff disagrees. 83 Ill. Adm. Code 285, Section 285.4010 states that short-term debt should be included in the capital structure unless the Company demonstrates that short-term debt is entirely financing assets that are not included in the utility's rate base. This burden is justifiably difficult because capital is fungible. Consequently, excluding short-term debt (or any type of capital) from the capital structure implies that excluded short-term debt can be traced to a non-rate based investment. In contrast, including short-term debt (or any other type of capital) in the capital structure recognizes that short-term debt cannot be traced to any particular asset. Under this circumstance, short-term debt is treated identically to long-term debt, preferred stock, and common equity; that is, short-term debt is financing <u>all</u> assets excepting construction-work-in-progress ("CWIP") in the exact same proportion of capitalization that short-term composes.[2]

This means that since short-term debt composes 18.21% of Nicor Gas' capital (Staff IB, p. 34), short-term debt is contributing 18.21% of the capital invested in each asset, whether in rate base or not. In any case, determining whether the Company relies on short-term debt to help meet the funding requirements of its rate base requires a deeper examination of the Company's rate base and short-term debt balances than implied in the Company's misleading and simplistic arguments. Ms. Freetly performed that analysis; the Company did not. From that analysis, Ms. Freetly found that the

[2] The Commission's uniform system of accounts assumes that short-term debt is the first source of funding for CWIP. (*Uniform System of Accounts for Gas Utilities Operating in Illinois*, Gas Plant Instruction 3(A)(17))

Company's rate base contains highly seasonal components that require a seasonal source of short-term funding. (Staff IB, pp. 37-38) Ms. Freetly also found that the Company's seasonal usage of short-term debt correlates very highly with the Company's seasonal rate base components: when the Company's seasonal rate base components increase, short-term debt balances increase. When the Company's seasonal rate base components decrease, short-term debt balances decrease. This pattern repeats year after year. The Company consistently relies on short-term debt as a source of financing, making it a permanent, seasonal source of funds. (See Staff IB pp. 36-37) Since Nicor Gas' seasonal, rate-based working capital requires such a seasonal source of funding on an annual cycle, it should be included in the capital structure for rate setting purposes.

In its three previous rate cases, Docket Nos. 04-0779, 95-0219 and 87-0032, the Company did not include cash working capital in rate base and the Commission did not include short-term debt in the Company's capital structure. The Company claims that the Commission should exclude short-term debt from the capital structure in this case as well. (Co. IB, pp.49-50) However, this case is distinguishable from those past rate cases because Nicor Gas is including cash working capital in rate base. The components of cash working capital exhibit a highly seasonal pattern. This variable rate base asset requires a variable source of funding. The issuance of short-term debt allows the Company to meet that seasonal need for capital. (Staff Ex. 18.0C, pp. 6-7)

Staff agrees with the Company that funds cannot be definitively traced from source to use. (Co. IB, p. 52) Nevertheless, that too is an unnecessary diversion since Staff is not linking short-term debt with particular assets, which would require tracing. Staff is only pointing out that the variable seasonal components of rate base create a variable seasonal need for funds. The average balances of cash working capital and gas in storage that are included in rate base obscure, but do not negate, the fact that actual monthly balances of those accounts vary greatly with the seasonal pattern of the Company's operations. The cash working capital balance included in rate base is represented by a single amount, an average, which masks the highly seasonal pattern of its various components, such as accounts receivable. For the year 2009, the monthly forecasted balance of customer accounts receivable varies from a high of $634,638,000 in March 2009 to a low of $185,829,999 in August 2009. The thirteen month average of customer accounts receivable for December 2008 through December 2009 is $391,980,000, which nearly equals the operating revenue lag component of the cash working capital requirement of $391,001,983. Hence, the number behind the operating revenue lag is highly seasonal, prompting the need for a seasonal source of capital. The Company cannot satisfy the seasonal need for funds created by the variable portion of its rate base without the use of short-term debt. (Staff Ex. 18.0C, p. 9)

The Company clearly resorts to short-term debt to supply the cash that it needs to pay its obligations (primarily the purchase of gas) during its seasonal build-up of working capital. During that period, the Company's cash obligations exceed customer receipts. The Company then draws down its working capital during the portion of the year customer receipts exceed its cash obligations, and uses the surplus cash to retire short-term debt. (Staff Ex. 18.0C, pp. 7-8) In summary, working capital creates a seasonal need for additional cash, which Nicor Gas satisfies by issuing short-term debt.

Short-term debt is added to the pool of funds available to the Company, which then enables the Company to fund its working capital requirements.[3]

The Company claims that Staff's recommended capital structure is not commensurate with a strong degree of financial strength and that including short-term debt would degrade Nicor Gas' credit profile. (Co. IB, pp. 52-53; Co. Ex. 24.0, p. 20) The Company is wrong. Staff witness Kight-Garlisch compared the financial strength implicit in Staff's recommended revenue requirement for the Company to Moody's Investors Service ("Moody's") guidelines for the regulated gas distribution industry. Staff's ratio analysis concluded that under Staff's proposed revenue requirement (which incorporates Staff's recommended capital structure) the Company's financial strength is commensurate with an Aa3 rating for Nicor Gas. (Staff Ex. 19.0C, pp.3-4) Hence, Staff showed that the inclusion of short-term debt in the capital structure for ratemaking purposes would not degrade Nicor Gas' credit profile.

The Company further claims that Staff's ratio analysis is based on an incorrect methodology and thus does not properly reflect the impact from Staff's proposal. (Co. IB, pp. 52-53) Unfortunately, neither the Company nor Mr. Ruschau explain how Ms. Kight-Garlisch's analysis differs from Moody's methodology. Rather, the Company left it to the Commission to draw its own inferences from Company Exhibit 24.6. Ms. Kight-Garlisch reviewed that document and concluded that two of the adjustments were appropriate and the other two were not. Staff properly adjusted the ratios for operating leases and pension credits. Staff did not adjust the ratios for pension service costs, since Staff has included those costs in its proposed revenue requirement; therefore, the

[3] A short-term debt issuance that "enables a company to fund working capital requirements" does not mean that the specific cash raised through that short-term debt issuance is necessarily used to purchase working capital. Rather, short-term debt fills the company's pool of funds until it is large enough to purchase working capital.

Company would receive revenue to offset pension service costs such that the Company's operating income is unaffected. (Staff Ex. 19.0, p. 3)

Staff also relied on the average short-term debt balance, instead of an end-of-year balance relied on by the Company (Co. Ex. 43.0 pp. 11-12) for three reasons. First, the ratios should reflect Staff's recommended capital structure in this case. Second, Staff's recommended balance of short-term debt is consistent with the requirement of 83 Ill. Adm. Code 285.4020(d)(1). Third, Staff's use of an average balance is consistent with the analysis described in Moody's June 12, 2008 report on Nicor Gas. (Staff Group Cross Ex. 1, JF 3.06, p. 3)

The Company also contends that its proposed expenditures and revenues should be the starting point to calculate the financial ratios and that Staff's ratio analysis underestimates the effect of Staff's proposed revenue requirement. (Co. IB, p. 52; Co. Ex. 24.6) This is wrong. Staff's ratio analysis accurately shows the Commission the financial strength of Nicor Gas that would result should the Commission accept Staff's proposed rates. (Staff Ex. 19.0, pp. 1-2) To the extent the Commission accepts Staff's position on expenditures, the Commission is concluding either the Company *will not* be spending as much as the Company forecasted or that rate payers should not compensate the Company for a portion of the expenditures that the Company forecasted. In the former case, Staff's position on those expenditures is obviously valid for calculating the Company's financial ratios since the Commission would have deemed the Company's forecast of expenditures was less credible. In the latter case, Staff's position on those expenditures is again valid; if the Commission were to use the Company's proposed expenditures for the calculation of the Company's financial ratios, the ratepayers would be at least partially compensating Nicor Gas for the portion of the expenditure that was disallowed through an improperly adjusted rate of return. Therefore, ratios based on Staff's recommended expenditures accurately present Nicor Gas' prospective financial strength under Staff's proposed revenue requirement. (Staff Ex. 19.0, p. 2)

b. Adjustments to Other Capital Components Based on the Calculation of CWIP accruing AFUDC Balances

The Company claims that Staff's adjustments to the balances of long-term debt, preferred stock and common equity, based on the calculation of Construction Work in Progress ("CWIP") accruing an Allowance for Funds Used During Construction ("AFUDC"), are not necessary. (Co. IB, p. 53) As discussed in Staff's Initial Brief, the Commission's formula for calculating CWIP accruing AFUDC assumes that short-term debt is the first source of funds for financing CWIP and that any CWIP not funded by short-term debt is funded proportionally by the remaining sources of capital (i.e., long-term debt, preferred stock, and common equity). In Docket No. 06-0070, the Commission adopted Staff's recommended capital structure for Central Illinois Public Service, which included the adjustment for CWIP accruing AFUDC to the balances of long-term debt, preferred stock and common equity. Thus, if the Commission includes short-term debt in Nicor Gas' capital structure, it must also apply Staff's CWIP accruing AFUDC adjustment to long-term debt, preferred stock and common equity. (Staff IB, pp. 42-44)

2. Cost of Short-Term Debt

The Company maintains that the appropriate cost of short-term debt for Nicor Gas is 3.72%. (Co. IB, p. 53) As stated in Staff's Initial Brief, the Company's cost of short-term debt should be rejected by the Commission because it is based on a LIBOR rate, not the rate the Company actually pays on short-term debt. Staff's 2.50% cost of short-term debt is superior because it is properly based on a current estimate of the commercial paper rate and includes the bank commitment fees the Company incurs to maintain the bank lines of credit that support its commercial paper program. (Staff IB, pp. 11-12) The Commission should apply Staff's cost of short-term debt to the balance of short-term debt included in Nicor Gas' capital structure.

3. Cost of Common Equity

a. Return On Equity ("ROE") Calculation

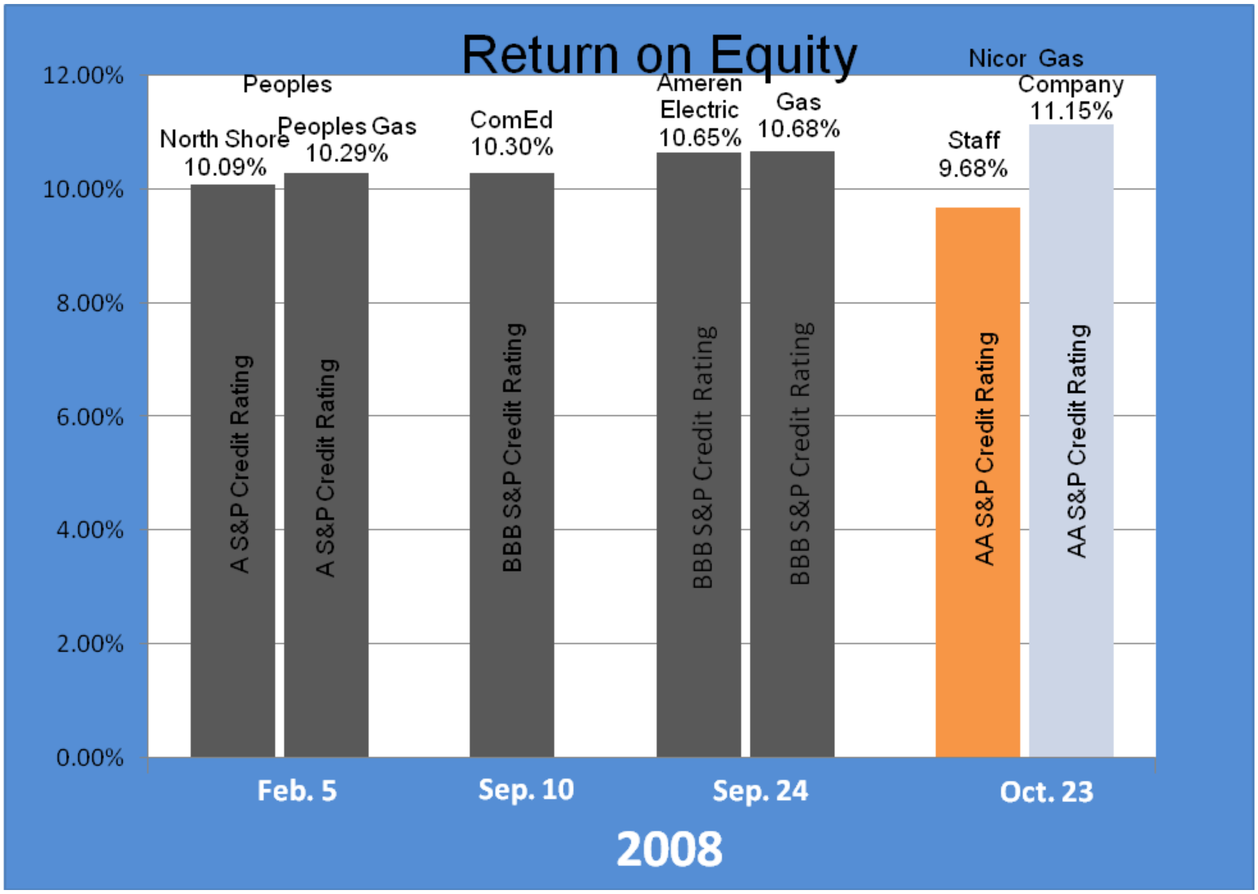
Response to Company's ROE Calculation Arguments

The Company makes four faulty arguments regarding Staff's ROE calculation. The Company's Initial Brief criticizes Staff's (1) recommended return on equity, (2) beta estimate, (3) DCF growth rates, and (4) downward adjustment.

Recommended Return on Equity

The Company asserts that Staff's recommended return on equity is "at odds" with recent Commission decisions. (Co. IB, 54) The Company's assertion is completely false. In fact, Staff's return on equity recommendation is consistent with the allowed returns granted in recent Commission rate cases when total risk of each utility is considered. As can be seen in the table below, Nicor Gas has less total risk, as measured with credit ratings,[4] than any other utility in the table. Since investors require lower returns from companies with less risk, Nicor Gas should be authorized a lower rate of return on common equity than Peoples Gas/North Shore Gas, ComEd, and the Ameren Companies. In fact, it is obvious from the comparison in the table below that the Company's requested return on equity of 11.15% is unreasonably high.

[4] Investment grade credit ratings listed strongest to weakest are AAA, AA, A, and BBB.



(Co. IB, p. 54; Tr. p. 504, Nov. 19, 2008)

<u>Beta Estimate</u>

The Company argued that Ms. Kight-Garlisch should have used "objective and published betas." (Co. IB, 55) Ms. Kight-Garlisch did use "objective and published betas." (Staff Ex. 19.0C, pp. 10-13) To reduce issues in this case only, Ms. Kight-Garlisch updated her analysis in rebuttal testimony to incorporate published beta estimates. (Staff Ex. 19.0C, pp. 10-13) The Company now wants the Commission to reject Ms. Kight-Garlisch's betas because it claims they are "subjective and unreliable." (Co. IB, p. 57) The Company provided no evidence to support this claim. In fact, Staff showed that the adjusted published betas are consistent with its calculated regression beta. (Staff Ex. 19.0C, p. 10)

The Company also argues that Ms. Kight-Garlisch's published sources should not be relied on for the beta estimation, since they "lack Commission precedent." (Co. Ex. 44.0, p. 1; Co. IB, p. 56) If Commission precedent is a concern for the Company, then it would not have argued against Staff's regression beta, since the Commission has accepted Staff's regression beta in numerous previous proceedings.

Further, in surrebuttal, Company witness Dr. Makholm identifies that his problem with published betas is that they are unadjusted. (Co. Ex. 44.0, p. 4) Nicor Gas cannot have it both ways. If, as Dr. Makholm argues, betas should be visible to the investors, then the published beta should be used as presented in the published source. Therefore, if the Commission should decide to disregard its own precedent and finds Dr. Makholm's initial argument that the beta should be readily visible to the investor convincing, then it must rely on the beta that is actually published. In this case, that would be both raw and adjusted beta estimates. (Staff Ex. 19.0C, pp. 10-11)

In summary, the Company's arguments against Staff's betas are inconsistent. It has not based any of its objections to Staff's beta estimates on any principled adherence to a particular method of calculating beta, but instead appears to be based on a desired outcome. Furthermore, the Company has provided no evidence that the Value Line beta the Company wrongly posits the Commission relies solely upon is superior to the beta estimates from four reputable sources presented by Staff. (Staff Ex. 19.0C, pp. 10-11) Therefore, the Commission should disregard all of the Company's criticisms of Staff's beta.

<u>DCF Growth Rates</u>

The Company claims that Staff's "third-stage growth rates, at best, rely upon unsupported assumptions and, at worst, fundamentally misapprehend the field of utility productivity analysis." (Co. IB, p. 57) The Company's claim fails on two levels. First, Staff provided support from published and widely used finance textbooks for the use of gross domestic product ("GDP") as the terminal (i.e., third-stage) growth rate. (Staff Ex. 19.0C, pp. 6-7) Second, the Company's attempt to confuse the issue of proper growth rate with productivity analysis has failed. The Company bases its claim that Staff does not understand the significance of productivity to utility earnings growth. (Co. Ex. 25.0, p. 8) In other words, rather than provide facts to support its position, the Company simply claims its analysis is not understood. However, despite two opportunities to do so, Dr. Makholm failed to show any direct link between productivity and a company's growth in earnings. In contrast, Ms. Kight-Garlisch provided uncontroverted testimony that for productivity to lead to higher growth in earnings, as Dr. Makholm claims, productivity gains cannot be passed on to: (1) customers through lower prices, (2) workers through higher wages, or (3) common stock holders through higher dividends. Clearly, as rate regulated entities, utilities pass productivity gains through to customers. Further, the record clearly demonstrates that utilities have below average earnings retention and should have below average rates of return on new investment. Thus, even if utilities have above normal productivity growth, that productivity growth does not lead to above normal growth in earnings. (Staff Ex. 19.0C, p. 7) Significantly, productivity is not a component of Dr. Makholm's sustainable growth rate formula, which has only two components: expected retention rate and expected return on common equity. (Co. Ex. 10.8)

<u>Downward Adjustment</u>

The Company argues that Dr. Makholm has shown that Ms. Kight-Garlisch's downward adjustment "has no basis in financial theory or practice." (Co. IB, pp. 57-58)

This argument is wrong. Staff's initial brief completely refutes this argument. (See Staff IB, pp. 57-58) In addition, Dr. Makholm criticizes Ms. Kight-Garlisch of taking "no care with her 25 basis point adjustment." (Co. Ex. 25.0, p. 23) This is a remarkable criticism given the great care and openness to valid, constructive criticism with which Ms. Kight-Garlisch conducted the detailed ratio analysis underlying that adjustment. In contrast, the critic, Dr. Makholm, is a highly paid professional witness who did not respond to the analysis presented by Ms. Kight-Garlisch in this case. (Tr. pp. 441-446, Nov. 19, 2008) Instead, Dr. Makholm's response to Ms. Kight-Garlisch's risk analysis is virtually identical to his response to the adjustment made by another Staff witness in Docket No. 04-0779. (See Tr., Nov. 19, 2008, pp. 442-447; Staff Cross Ex. 2.0 and Order, Docket No. 04-0779, September 20, 2005, p. 78) In that docket, Staff relied only upon the average Standard and Poor's ("S&P") credit ratings and business profile scores to determine its adjustment. However, in this case, Ms. Kight-Garlisch performed a detailed ratio analysis of both the Company and the Utility sample in order to compare their relative financial strength. The resulting ratios were translated into implied credit ratings, based on Moody's guidelines for the regulated gas distribution industry, only to have a metric on which to base an adjustment to the cost of equity. (Staff Ex. 6.0C, pp. 21-25) Thus, Dr. Makholm's response was to an analysis that was not even presented in this case! (Co. Ex. 25.0, p. 25) Dr. Makholm's explanation for his error – he "misspoke" (Tr. p. 442, Nov. 19, 2008) – further reinforces the evident carelessness with which he undertook his work in this proceeding.

Dr. Makholm has not only failed to address the testimony of Ms. Kight-Garlisch on the downward adjustment to the cost of equity, but he also failed to address the analysis presented by CUB witness Mr. Thomas, regarding his empirical beta analysis.

Instead, Dr. Makholm dismissed Mr. Thomas' analysis as previously rejected by the Commission (Co. Ex. 25.0, p. 22), even though the Commission has never had the opportunity to consider this new information. (CUB Ex. 2.0, p. 7) In addition to these two blatant errors by Dr. Makholm, he has also failed to research Commission precedent on betas and research how companies in his sample raise common stock both publicly and privately. Instead of researching all common stock issues, Dr. Makholm only looked at public issues; he never reviewed the issuances from stock options. (Staff Ex. 19.0C, p. 32). Dr. Makholm also neglected to consider financial risk in his recommendation of the cost of equity for Nicor Gas.

b. Effect of Proposed Riders

The Company asserts that riders do not affect business risk. (Co. IB, p. 59) The Company is mistaken. Reducing the volatility in cash flows of a company reduces business risk. Since the riders proposed by Nicor Gas reduce volatility in cash flows, they also reduce the Company's business risk. Further, both Moody's and S&P consider rate design mechanisms, such as decoupling, as favorable for credit ratings. (Staff Ex. 19.0C, p. 15)

4. Overall Cost of Capital (Derivative)

The Commission should adopt Staff's recommended rate of return on rate base of 7.35% for Nicor Gas. The derivation of Staff's rate of return recommendation is shown below.

Weighted Average Cost of Capital
Average 2009

Staff Proposal

	Amount	Percent of Total Capital	Cost	Weighted Cost
Short-term Debt	$255,640,082	18.21%	2.50%	0.46%
Long-term Debt	$495,195,694	35.27%	6.80%	2.40%
Preferred Stock	$1,386,144	0.10%	4.77%	0.00%
Common Equity	$651,818,845	46.42%	9.68%	4.49%
Total Capital	$1,404,040,765	100.00%		
Weighted Average Cost of Capital				**7.35%**

VII. Cost of Service and Allocation Issues

A. Overview

B. Uncontested Issues

1. Allocation Factor Based on Services Investment by Customer Class

2. Allocation of Storage Losses

C. Contested Issues

1. Main Size Allocation

IIEC's arguments for its proposed revision to the average demand component of the Company's proposed A&P allocator should be rejected. IIEC argues that not allocating the average component of costs for smaller mains to larger customers "will significantly improve the accuracy of the Nicor Gas study and ensure that the costs of smaller mains, which are in many instances not even used by larger customers, are not allocated to those customers." (IIEC IB, p. 10)

The proposed revision conflicts with the principles on which the A&P allocator was developed. The average demand component of the allocator “recognizes the role of year-round demands in shaping transmission and distribution investments.” (Staff Ex. 7.0, pp. 25-26) Stated otherwise, the Company requires year-round demands by all customers to justify the investment in a transmission and distribution (“T&D”) system which consists of both large and small mains. It would be unreasonable to assume that investors justify a T&D system in two stages by deciding whether demands by all customers are sufficient to justify the large T&D mains and demands by smaller customers are sufficient for the construction of smaller mains as well. Thus, this economic justification to build the T&D system is appropriately reflected in an average allocator for all customers that applies to all T&D mains. Therefore, IIEC’s proposed revision to the Company’s A&P allocators should be rejected.

2. Allocation of Storage Costs to Unbundled Rate Classes

D. Interclass Allocation Issues

IIEC argues against the Company’s proposal to bring the residential class rates to only 97.5% of its full cost of service instead of 100%. While acknowledging gradualism as an important principle, IIEC contends that bill impact concerns should apply to all classes, not just the residential class. (IIEC IB, p. 12) These concerns can be dismissed by the Commission. Even with this limitation, the Company’s proposal recovers approximately 80% of its proposed base rate increase from the residential class. (Tr., Nov. 19, 2008, pp. 541-542) Thus, the Commission can be assured that the residential class will pay a reasonable share of the proposed increase under the revenue allocation proposed by Nicor Gas. It would be onerous to require the residential class to pay even more as IIEC recommends.

VIII. Rate Design

A. Overview

B. Uncontested Issues

1. Rate 6 and Rate 76 Design

C. Contested Issues

1. Rate 1 Design

2. Rate 1 Design and Conservation

3. Rate 1 Design – Alternative Straight Fixed Variable

The arguments presented in the Company's Initial Brief cannot hide the significant defects in its proposed residential rate design for this proceeding. That rate design favors shareholders at the expense of cost of service, conservation and fairness to ratepayers. The only reasonable alternative for the Commission is to reject the Company's rates in favor of Staff's proposed rates which further the objectives of cost and efficiency while balancing the interests of shareholders and ratepayers.

With the weight of evidence in this case clearly stacked against its proposals, Nicor Gas seeks to shift the discussion to other cases involving other gas utilities in Illinois. The Company argues that rates and riders granted to other utilities should automatically be accepted for Nicor Gas regardless of the weight of evidence in this proceeding. Nicor Gas argues for a significant customer charge increase for residential customers by assuring the Commission that the resulting charge would only move "to the middle of the range of current monthly customer charges for other gas utilities in Illinois." (Co. IB, p. 69) In a similar vein, the Company states that its proposed approach "is consistent with recent Commission decisions that recognize the need for utilities to recover their fixed costs in an environment where per customer usage is declining." (*Id.*, p. 70) The Company then criticizes Staff's rate design for being "directly inconsistent with the Commission's recent actions." (*Id.*, p. 73)

These arguments reveal the limitation of the Company's case for its proposed rate design. There is no question that recent Commission decisions have favored the recovery of demand costs in customer charges. However, those decisions are not binding on the current docket. Furthermore, the Company should not consider itself entitled to benefits conferred on other gas utilities, regardless of the evidence in this case.

Nevertheless, there is good reason for the Company to shift its discussion to other dockets. That is because the substantial body of evidence in this docket does not support the Company's proposed customer charge increases for residential customers based on the straight fixed variable ("SFV") approach. The disadvantages of this approach include the following:

- It reduces ratepayers' incentive to conserve gas.
- It raises a consistency issue between how costs are caused and how revenues are collected.
- It conflicts with the Company's beliefs concerning cost causation for distribution costs.
- It creates an inequity for smaller customers who are required to pay the same for plant components as larger customers despite their smaller contribution to these costs.
- It could make it more difficult for ratepayers in financial distress to control their natural gas costs. (Staff Ex. 7.0, p. 34)

These problems which were discussed in detail in Staff's Initial Brief demonstrate the dangers that loom if the Company's proposed SFV rate design were adopted in this proceeding.

Nicor Gas also seeks to fortify its position by undermining the case for Staff's alternative approach. The Company finds fault with Staff's rate design because it "would increase winter bills, decrease summer bills and increase the Company's exposure to weather." (Co. IB, p. 73) The Company also criticizes Staff for proposing "higher distribution charges for the purpose of encouraging conservation." (Co. Ex. 29.0, p. 13) Nicor Gas believes the cause of conservation is better served by the programs covered by the proposed Rider EEP. (Co. IB, p. 74)

These arguments should be rejected. Staff's flat distribution charge should not be rejected just because it would lead to higher winter bills and lower summer bills than the Company proposal. There are good reasons to send ratepayers strong price signals in winter months to show that system costs are driven by demands during the peak winter heating system. The Company itself considers the peak demands an important driver of system costs which, in turn, would argue for higher rates in winter months. Higher base rates in winter also can relieve pressure on gas costs, which are the largest component of gas bills. To the extent that higher winter rates dampen winter demands, that will relieve upward pressures on gas costs. Higher winter bills will also encourage conservation by increasing the cost-effectiveness of heating season conservation measures and thereby motivating further efforts to curb gas demands during the peak season. (Staff Ex. 20, pp. 12-13)

The Company's argument that the cause of conservation is better served by the programs covered by the proposed Rider EEP (See Co. IB, p. 74) presents a particular concern. That argument fails to consider the significant cost for conservation programs that will be passed along to ratepayers through Rider EEP. In contrast, implementing a rate design that encourages cost-effective conservation entails minimal cost associated with reconfiguring how bills are calculated. It would be counterproductive to focus on expensive programs while ignoring low cost rate design tools to foster competition. (Staff Ex. 20, p. 16)

The Company further contends that "[f]ixed costs should be more closely associated with fixed charges and not with volumetric charges, because this association provides customers with accurate price signals for delivery service and provides Nicor Gas a reasonable opportunity to recover its costs." (Co. IB, p. 74) The argument is incorrect about the accuracy of price signals because the Company's own cost of service study indicates the costs in question are demand-related and therefore appropriately recovered in variable charges. Nicor Gas is correct in stating that the higher customer charges will provide the Company greater assurance of revenue recovery. However, this benefit to the Company will come at the expense of ratepayers, basic economic principles and conservation. This is an unacceptable price to pay in Staff's estimation.

4. Rate 4 and 74 Design

The Company criticizes Staff's proposed flat rate for Rate 4 and Rate 74 nonresidential customers. While conceding that "it may be an appropriate rate design for residential customers to have flat distribution rates after all fixed costs are recovered through a monthly customer charge because of the relative homogeneity of that class of customer," Nicor Gas rejects the flat rate concept for Rates 4 and 74 because the customers within that class "are not as homogenous." (Co. IB, p. 76) According to Nicor Gas, Rates 4 and 74 customers "range in size from very small store front companies using 30 therms a month for their water heater to large manufacturers using 65,000 therms a month." (*Id.*) The Company considers its proposed rate design for these two rates superior because it "accurately reflects the load profile of the customers on the rate and it will provide Nicor Gas a reasonable opportunity to recover its revenue requirement." (*Id.*)

There is no substance to the Company's argument on this issue. Beyond noting size disparities among customers within Rates 4 and 74, Mr. Mudra has failed to introduce any cost evidence in this proceeding to show how these disparities cause larger customers to be less costly to serve on a per-therm basis than smaller customers within the same class. Nor does the Company show how these alleged cost differences translate into the specific rate block structure proposed by Nicor Gas in this proceeding. Thus, the Company failed to buttress its position on this issue. (Staff Ex. 20, pp. 24-25)

The Company also criticizes Staff's proposed flat rate design as lacking because "the Commission considered similar Staff proposals in the 2004 Rate Case and properly rejected them." (Co. IB, p. 76) This statement fails to consider the meaningful evidence and arguments Staff proffered on behalf of its proposed flat rates in this proceeding. For one, Staff's proposed flat rate encourages efficient gas use and conservation by customers within the class. In contrast, the Company's proposed declining block rates undermine conservation by encouraging more, rather than less, consumption through an average price that declines as more gas is consumed. (Staff Ex. 20, p. 25) In addition, as has been well-documented, no evidence has been introduced in this proceeding to show that demands by larger customers are less costly to serve on a unit basis which is the economic foundation for a declining block rate. The only fair and reasonable alternative in this situation is to price all usage for the class at the same flat rate as proposed by Staff.

5. Rate 5 and 75 Design

Nicor Gas claims that Staff still supports annual maximum eligibility limit of 1.5 million therms after the agreement. (Co. IB, p. 78) Staff had no opportunity in its testimony to comment on the agreement. However, in its Initial Brief, Staff accepted the 700,000 maximum which Nicor accepted in the settlement. (Staff IB, p. 96)

Nicor Gas provides an incomplete discussion of the issue of seasonal rates for nonresidential customers. This is an important issue because the Company, after objecting twice to increasing eligibility for the rate (Co. Ex. 29.0, pp.22-23; Co. Ex. 48.0, p. 27), has now found it fit to accept this increased maximum. (Co. IB, p. 78) However, the Company failed to provide any assumption about the percentage of newly eligible customers that will migrate to these rates. The only reference to the issue in the Initial Brief was a statement that "Only about 10% of customers eligible for these rates have decided to take seasonal rate service which causes *cost allocation issues.*" (Co. IB, p. 78, emphasis added)

The Company did make reference to the issue in the hearing process when it stated that "the [C]ompany will update its [ECOSS] to *reflect* the new number of *eligible* customers to be included in Rates 5 and 75." (Tr., p. 632, Nov. 19, 2008, emphasis added) However, Nicor Gas failed to explain the specific updates it plans to make.

Given this lack of explanation by the Company, Staff continues to believe that the only possible penetration rate for migration by newly eligible customers to seasonal rates is 10%. As indicated above, that is the percentage of customers that have so far switched to this rate and the Company has not provided any evidence that newly eligible customers will switch at a greater or lesser rate.

There is a potential problem of overearnings associated with this switching rate issue. As noted in Staff's Initial Brief, "Staff believes the most reasonable assumption for ratemaking purposes is that 10% of eligible customers subscribe to seasonal service….An assumption of a participation rate of greater than 10% creates the potential for overearnings." (Staff IB, p. 96) While the Company has not been forthcoming on this migration issue, Staff is concerned that Nicor Gas might use an alternative assumption that 100% of eligible customers will take service under that seasonal service. Staff believes this assumption would create the potential for overearnings. Because the seasonal rates (5 and 75) are lower than current rates for these customers (4 and 74), the higher the switching rate assumed the greater the revenue shortfall that rate 4 and 74 customers will be required to assume. If the assumed switching rate is over-estimated, rates will over-collect the revenue-requirement revenue producing overearnings.[5] That is why Staff wants to ensure that Nicor Gas uses a reasonable assumption. Any assumption greater than 10% would be improper as any other figure would be unsupported by the record and would directly contradict the Company's testimony that "few, if any, of these [eligible] customers would actually subscribe to Rates 5 and 75 services." (Co. Ex. 48.0, p. 27)

Therefore, Staff makes a two-fold recommendation on this issue. One is to continue to recommend that the Commission approve the expansion of seasonal service to 700,000 therms annually. Second, Staff recommends that the Commission expressly approve rates based on the assumption of a 10% subscription rate.

[5] Because there will be more customers remaining on the higher rates, the Company will over-recover in the oversubscribed, higher rates more than they under-recover in the undersubscribed, lower rates.

Specifically, the Commission should direct the Company to update its ECOSS to reflect that 10% of the new number of *eligible* customers to be included in Rates 5 and 75.

(a) Overview
(b) Annual Therm Limitation

6. Rate 7 and 77 Design

Both Nicor Gas and IIEC defend the Company's proposed rate structure for this class in their respective Initial Briefs. The Company's argument is perfunctory. The level of increase in tail block demand charges proposed by Staff is noted and the Company abruptly concludes that such an increase should be rejected. (Co. IB, p. 79)

IIEC presents a considerably longer discussion and claims to identify a number of reasons for rejecting Staff's proposed rate design for Rates 7 and 77. For one, IIEC argues that the proposed increase in Staff's proposed tailblock demand charge of 1,000 percent "clearly violates the principle of gradualism." According to IIEC, "[s]uch an increase could produce close to triple digit increases for some Rate 77 customers. (IIEC IB, p. 15) IIEC further contends that Staff "did not adequately consider the rate impacts" of its rate design proposal for the class because the largest customer in Staff's bill comparison uses only 500,000 therms while the average customer on Rate 77 uses almost 1,000,000 therms per month and some customers much more. (*Id.*, p. 15)

Contrary to IIEC's claim, the evidence indicates that customers in this class will not realize a significant or disproportionate increase in the total amount they pay for gas service as a result of Staff's proposed rates. As Staff has shown, customers on Rate 77 pay an average of 3.2 cents per therm distribution charge under the Company's proposed rates. In contrast, Staff showed that the average market price for natural gas is about 65 cents per therm. Thus, the 3.2 cents per therm average charge represents less than 5 percent of that average market price for natural gas. This demonstrates that base rates represent only a small portion of the total amount these customers pay for gas. That means that even if base rates were to increase significantly, the overall cost for gas service for these customers would increase modestly. Therefore, Staff correctly concluded that the rates to be paid by these customers is consistent with the principle of gradualism. (Tr., Nov. 19, 2008, pp. 538-539)

IIEC goes on to contend that the Staff proposal to eliminate the declining block demand charge structure for Rates 7 and 77 conflict with the cost of service. IIEC contends that "there are economies of scale in serving larger loads, and that indeed this is manifest in the cost of service study." (IIEC Ex. 2.0, pp. 27-28) Dr. Rosenberg's contentions regarding the economies of scale inherent in serving large customers were supported by Nicor Gas witness Mr. Mudra. (Co. Ex. 48.0, p. 24; IIEC IB, p. 15) However, the only statement by Mr. Mudra on the subject is an unsupported claim that the proposed declining block charges "reflect the economies of scale that arise from serving larger customers." Thus, the only support IIEC can find for its position concerning economies of scale is a single, unsupported statement from the Company. This testifies to the weaknesses of IIEC's argument on this issue.

IIEC also professes concern that Staff's proposal to eliminate the declining block rate structure "would greatly magnify the impact on Nicor's revenues should the demands of these large customers change from the presumptive use." (IIEC IB, p. 15) IIEC goes on to speculate that variations in usage could thereby result in windfall profits or an earnings shortfall. (*Id.*, pp. 15-16) The issue here is whether rates should be designed to reflect costs or to stabilize the flow of revenues to the Company. At certain junctures, IIEC professes to be concerned about costs. Now, it is apparently concerned about the Company’s revenue flow. Thus, at this late juncture it is not clear what principles IIEC believes should be applied in the design of the Company’s retail rates.

7. Other

IX. Tariff Revisions Affecting Transportation Customers

A. Overview

B. Uncontested Issues

1. Individual and Group Administration Charges

2. Recording Device Charges

3. Group Change Fees

4. Transportation Service Credit

In surrebuttal, Nicor Gas updated its credit for the carrying costs of working gas to the Transportation Service Credit (“TSC”) from $.0037 to $.0045 to reflect changes in the ECOSS. (Co. Ex. 48.0, pp. 66-67) Staff recommends that the Commission approve this change to the TSC.

5. Gas Supply Cost / Demand Gas Cost

6. Timing of MDCQ

C. Contested Issues

As discussed at length in Staff’s Initial Brief, Nicor Gas’ proposals are inconsistent with the methodology adopted by the Commission in the Company’s most recent rate case, Docket No. 04-0779. (See Staff IB, pp. 101-127) This inconsistency appears in Nicor Gas’ proposal regarding reductions in Maximum Daily Nominations (“MDN”) and the Storage Banking Service (‘SBS”) calculations. In regards to the MDN, Nicor Gas made no reference to the prior case. (Co. IB, pp. 81-84) In regards to the SBS calculations, Nicor Gas makes only a passing reference that 149.74 Bcf was what was “established” in the last case. (*Id*., pp. 85-89) In addition, the Company misrepresents Nicor Gas’ initial Storage Withdrawal Constant (“SWC”) formula as having “minor differences” from the formula approved in 04-0779. (*Id*., pp. 86, 89) Nicor Gas has had more than adequate time to address the connection to 04-0779 in its testimony or Initial Brief, but has failed to do so. If Nicor Gas now uses its reply brief to provide reasons why the Commission's previous objections were unfounded, these reasons should be given no consideration because it had opportunity to address those objections earlier and because offering them at this point precludes parties from rebutting Nicor Gas' points.

1. Proposed Reductions in Nomination Rights

General Overview of Staff's Concerns

Although most of Nicor Gas' objections fall under the heading of "Reduction of Maximum Daily Nominations ("MDN") in the months of July through October" (Section IX.C.1.a) and "Reduction of Maximum Daily Nominations ("MDN") in the months of March and April" (Section IX.C.1.b), Staff will address most of those issues under this heading.

Again, nothing that Nicor Gas has done has addressed the Commission's specific concerns. It is hard to have a meaningful discussion on this subject when Nicor Gas refuses to address the context both in testimony and its Initial Brief. This fact shows the weakness in Nicor Gas' position.

Operational Argument

Nicor Gas argues in its Initial Brief that the MDN reductions "make sense because they more closely match customer's storage utilization with actual storage field requirements." (Co. IB, p. 82) Nicor Gas point to the cycling requirements in its storage fields as part of its rationale for why transportation customers should be forced to cycle their banks. Nicor Gas lists two disadvantages that exist without cycling: declining reservoir performance and lower reservoir pressures. (Co. IB, p. 83) However, Nicor Gas witness Bartlett states several times that under current tariffs, performance is up and pressures are up. Specifically, he has stated that the hysteresis curves in Co. Ex. 19.2 show that “operating at lower inventory levels ... has *improved* storage field *performance*” and “there has been a progressive *improvement* in reservoir *pressures* at various inventory levels.” (Co. Ex. 19.0, pp. 12-14) This improved performance occurs despite this same witness’ warning of decreased performance absent Nicor Gas’ proposed MDN measures. (Co. Ex. 4.0, p. 27) Thus, actual experience debunks Nicor Gas’ rationale regarding the need for parity between the transportation banks and storage fields.

Nicor Gas claims that its proposal will be operationally beneficial. “The Company fully anticipates this MDN level will be sufficient to allow the customer to satisfy all of its delivery requirements.” (Co. IB, p. 83; Co. Ex.4.0, p. 29) This statement is misleading because it implies that Nicor Gas has been unable to meet its delivery requirements. However, Nicor Gas has not presented any evidence that it has not been able to meet its delivery requirements. These hollow threats should not be given any weight as there is nothing in the record to support them.

Nicor Gas also claims that because transportation customers’ usage has not been at levels necessary to issue caps, the March and April reductions would have no impact on transportation customers. (Co. IB, p. 84; Co. Ex. 19.0, p. 17) However, there is no established connection between transportation customers’ nominations and the pipelines caps. Additionally, Nicor Gas has admitted that historically these reductions would have had between a 23% and 69% reduction in nomination rights during the 6 months that are being reduced. (Staff Ex.11.0R, pp. 7-8, 17-18) Therefore, the reductions *will* have a detrimental effect in reducing transportation customers’ flexibility, but may have no benefit in reducing caps.

What Nicor Gas' claim really means is that transportation customers are not using maximum levels now. And this means that the current levels are manageable, at least from a pipeline cap perspective. There does not appear to be a problem with respect to the level of rights since Nicor Gas is experiencing no caps with the current levels of rights and transportation customers are not using their full rights. In addition, Nicor Gas has never shown that its reductions will even have the effect that it attempts to portray as necessary. In fact, it has stated that its proposals will not eliminate the potential for pipeline caps. (Co. Ex. 4.0, p 29)

Staff provides an extensive discussion of why the Commission should reject both reductions in MDN in its Initial Brief at pp. 101-109. Nothing in the Company's Initial Brief refutes Staff's analysis. The Company's argument that increased cycling is beneficial may have merit; however, it has failed to show that these proposals are necessary.

(a) Reduction of Maximum Daily Nominations ("MDN") in the months of July through October

(b) Reduction of Maximum Daily Nominations ("MDN") in the months of March and April

2. Storage Calculations

The Storage Banking Service ("SBS") provides access to Company storage assets for transportation customers. There are three parameters, Entitlement, Charge, and Withdrawal Factor, related to the SBS whose calculations are contested. Currently, all three of these parameters are calculated using Nicor Gas' non-coincident historical top gas capacity of 149.74 Bcf. (Staff IB, p. 112)

Although most of Nicor Gas' objections fall under the heading of "SBS Entitlement" (Section IX.C.2.a), Staff will address most of those issues at the same time in these introductory paragraphs because the three parameters are interrelated and most of the arguments apply to all three calculations. This is consistent with Staff's organization in the Initial Brief, where Staff addressed its general objections in the overview portion. Unless specifically noted, these general arguments should be taken to apply to all issues and only those that are exclusively related to individual issues are addressed in the sub-headings.

Nicor Gas seeks to dismiss Staff's entire argument, which is summarized in Staff's Initial Brief at pp. 112-118, because it avers that Mr. Sackett incorrectly *describes* the Company's formula used to calculate the SBS *entitlement*. (Co. IB, p. 86) While this dismissal no doubt would be convenient for Nicor Gas, Mr. Sackett's formula clearly refers to Nicor Gas' calculation of the SBS *Capacity Allocation* and not the SBS *entitlement*. (Staff Ex. 24.0R2, p. 19) The SBS Capacity Allocation is an unprecedented calculation that Nicor Gas' witness Mudra made in his response to DR CNE 2.01 and his rebuttal testimony. (Co. Ex. 29.0, pp. 45-46) Staff demonstrated that Mr. Mudra had created a circular calculation. (Staff Ex. 24.0R2, p. 19) While it is technically correct that Mr. Mudra did not use the *137.2 Bcf value* to calculate the SBS entitlement, he did use the SBS allocation to do so. Thus, Nicor Gas' dismissal of Staff's valid objections is based on a misrepresentation of Mr. Sackett's testimony. Moreover, none of Staff's other arguments depend on this allegedly incorrect *description*.

Staff did not point out at the time that Mr. Mudra had calculated two different values for the SBS allocation, one of 137.2 Bcf (Staff Ex. 24.0R2, Attachment C) and another of 134.6 Bcf. (Staff Ex. 24.0R2, Attachment D) He used the former to calculate the SWC and the latter to determine the SBS entitlement.[6] Mr. Mudra then backed away from the SBS Capacity Allocation of 137.2 Bcf in his surrebuttal testimony, admitting that it was without precedent in 04-0779. (Co. Ex. 48.0, pp. 50-51) This admission is contrary to Mr. Bartlett's testimony (Co. Ex. 4.0, p. 24), Mr. Mudra's testimony (Co. Ex. 29.0. p. 45), and DR response (Staff Ex. 24.0R2, Attachment C).

The Company resumes its usage argument again, stating the 134.6 Bcf is more in-line with "actual experience" and represents the maximum amount that customers can "use." (Co. IB, p. 87) However, "actual experience" shows they used 138.9 in 2005 (Co. IB, p. 87; Staff Cross Ex. 3, DAS 7.18.d), a greater amount than this "maximum." Here again we see Nicor Gas' return to usage arguments. As pointed out by IIEC, the usage argument has one fatal problem: it applies a double standard. To allocate storage entitlement based on usage while charging for that storage based on the capacity subscribed instead of used is unfair. Transportation customers as a group do not use the capacity that they subscribe to yet the pay for those rights anyway because they are reserving capacity. (IIEC IB, p. 23) The fairest method is to allocate both the entitlement and the charge based on capacity, because it uses a single and objective standard.

In its Initial Brief Nicor Gas makes only a few references to the 04-0779 case but never explains why the Commission should change its previous decision. The Company never addresses any of the concerns that the Commission raised about capacity being the appropriate measurement.

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[6] The record also shows that Mr. Mudra rounded the result of his SWC calculation to what he claims is "the nearest whole number". (Staff Ex. 24.0R2, Attachment B) However, 27.47 rounded to the nearest whole number is actually 27 and not 28.

Since the Company is basically trying to convince the Commission that the calculations should be based on *usage*, Staff's alternate proposal is based on that premise: that if *usage* is appropriate, there is a more-correct (and higher) measure of that usage than the one estimated by Nicor Gas for the current year. (Staff IB, pp. 116-117)

Staff recommends that the Commission order Nicor Gas to continue to base all three SBS calculations on 149.74 Bcf and consistently with the Commission's decision in 04-0779.

(a) Storage Banking Service ("SBS") Entitlement

Nicor Gas is proposing to retain 28 days of MDCQ of storage for transportation customers. Nicor Gas provided no basis in its direct testimony for entitlement of 28 days. Nor did it indicate why the calculation of said entitlement should remain at 28 days. (Co. Ex. 4.0, p. 22) Because of the decrease in peak design day from 5.28 Bcf to 4.9 Bcf, which is the denominator in the approved formula for determining the entitlement, the Commission should increase the SBS entitlement from 28 to 31 days. (Staff IB, pp. 117-118)

(b) Storage Banking Service ("SBS") Charge

Staff believes that it is inappropriate to base this capacity charge upon the volume of gas that Nicor Gas expects to achieve in storage. Rather, the charge should be based on the storage costs per unit of capacity in those fields. (Staff IB, pp. 118-119) Nicor Gas ignores Staff' objections and the Commission's historical guidance as noted above. Therefore, the Commission should increase the SBS charge from $.0029 per therm to $.0038 per therm of SBS capacity subscribed.

(c) Storage Withdrawal Factor

(i) Storage Withdrawal Constant

The Storage Withdrawal Constant ("SWC") determines the level of storage withdrawal for a transportation customer on normal winter and critical days. Nicor Gas changed its proposed SWC during the case. While Nicor Gas maintains only minor differences exist between the current method and its initial proposal (Co. IB, p. 89), Nicor Gas did not correct those minor differences as one might expect, *i.e.* by using the proposed capacity measure (134.6 Bcf) in the denominator of the formula approved in 04-0779 and currently in effect. Nicor Gas maintains that it "simplified" its SCW proposal in surrebuttal. (Co. IB, p. 89) Nicor Gas did not simplify its proposal; rather, it complicated it. The statement that the "purpose of the SWF is to derive a constant that, when multiplied by the SBS Entitlement days approved in this proceeding, yields a result that is approximately equal to the proportion of gas which can be withdrawn from Nicor Gas' storage field on a Critical Day" (Co. IB, p. 88) represents a departure from the prior order. There is no basis for this alleged "purpose" in this record nor did the Commission expressly rely upon this purpose when it approved Nicor Gas' proposed methodology in the last rate case. Nicor Gas' proclaimed "purpose" is inconsistent with the methodology it proposed, and the Commission approved, in Docket No. 04-0779. (Order, Docket No. 04-0779, Sept. 20, 2005, pp. 125-126)

Additionally, Nicor Gas has failed to explain why "purpose" or methodology would need to change. Nicor Gas' Initial Brief does not deal with why the old methodology was flawed, despite the fact that Nicor Gas' proposed this method in each of the past rate cases. The new methodology proposed by Mr. Mudra also contradicts Mr.

Bartlett's statement that the same capacity should be used in all three calculations. (Staff IB, p. 120)

Nicor Gas has also changed its position as to whether rounding is appropriate. It proposed to use rounding in its initial proposal when rounding the resulted in rounding *down* to 1.8% (Co. Ex. 14.0, p. 29); however, it now finds rounding to be unacceptable when the result rounded *up* to 1.9%. (Co Ex. 48.0, p. 52)

As discussed more fully in Staff's Initial Brief, Staff continues to recommend that the SWC be set at the current amount because the inputs into the formula are unchanged since the last rate case. (Staff IB, pp. 119-120) Therefore, Staff recommends that the SWC remains at 0.017.

(ii) Timing of the Storage Withdrawal Factor Calculation

IIEC proposed using a 30-day window within which each transportation customer would be able to achieve its 90% injection target. (IIEC IB, pp. 26-27) Nicor Gas objected in part because it did not have the daily usage data to provide these calculations. (Co. IB, pp. 89-90) IIEC objects in its Initial Brief to Nicor Gas' argument that its lacks sufficient data to calculate on the 15th of each month by stating that it was a red herring and that all Rate 76 and 77 customers are served by daily meters. (IIEC IB, p. 28)

Staff objects to the 30-day compliance window because the trading of stored gas could allow an end-run around the intent of the Commission. (Staff IB, p. 121) This might also apply to the more general case because this window might allow Rider 13 suppliers with more than one customer to shift injections under super-pooling from customer to customer each day to allow them to rise above the 90% target and then to be reduced below the Commission's stated intent.

Also, under IIEC's proposal, nothing would prevent individual customers from hitting the 90% target early on October 15th and then withdrawing to below it before November 1. This would deprive the Company of that gas for later in the year.

A one day target provides the best approach to achieving both the letter and the intent of the Commission's fall injection directive. (Order, Docket No. 04-0779, Sept. 20, 2005, p. 149) Trading of stored gas with a 30-day window, as proposed by IIEC, would not work, while trading of stored gas with a one day SWF calculation would work together to keep both the letter and the intent of the Commission.

CNE also supports the IIEC proposal and notes that "the transportation customers who would be required to abide by the terms support expanding the timing of the SWF calculation to 30 days." (CNE, IB, p. 35) However, Staff believes that it is not surprising that transportation customers would support greater flexibility than they currently have. Even if they now have no intention of circumventing the requirement, they would no longer be prevented from doing so.

Staff's proposal to allow trading of stored gas (See Staff IB, Section IX.C.5) will help users achieve the 90% target on November 1 as noted in Staff's Initial Brief. (Staff IB, p. 121) However, IIEC's proposal to establish a 30-day window would create perverse consequences that would lead to circumvention of the fall injection target when combined with trading of stored gas. (Staff IB, p. 121)

Therefore, Staff continues to recommend that the Commission order Nicor Gas to continue to calculate the SWF on November 1.

(iii) Other

3. Costs Associated with Storage and System Losses

(a) Storage Loss Adjustment ("SLA") Factor

Staff recommends that the Commission direct Nicor Gas to review its treatment of the allocation and recovery of system and storage losses at the same time that it is reviewing the methodology for calculating the amount of storage losses and the procedures for accounting for these losses. (See Section XVI.A, "Accounting for Storage Gas Losses") Nicor Gas should be directed to consult with Staff in this regard and, if warranted, to revise its treatment of the allocation and recovery of these losses. (Staff IB, p. 122)

(b) Unaccounted for Gas Adjustment ("UFGA")

While Staff does not object to the current assessment of the Unaccounted-For Gas Adjustment ("UFGA"), Staff recommends that the Commission order that during Nicor Gas' review of the methodology for calculating the amount of storage losses and the procedures for accounting for these losses (See Section XVI.A, "Accounting for Storage Gas Losses"), that Nicor Gas review with Staff and, if warranted, revise its treatment of the allocation and recovery of both storage and system losses through the UFGA. (Staff IB, p. 23)

4. Intra-Day Nominations

Nicor Gas objects to CNE's proposal to provide intra-day nominations and asserts that it was rejected in the last case, creates additional and unacceptable operational uncertainty and will impose costs on Nicor Gas customers. (Co. IB, pp. 91-93)

While the Commission rejected intra-day nominations in Nicor Gas' last rate case, it left the issue open for another look. (Order, Docket No. 04-0779, Sept. 20, 2005, p. 135) Furthermore, the Commission, in its most recent gas rate case decision, approved intra-day nominations. (Order, Docket No. 07-0585/07-0586/07-0587/07-0588/07-0589/07-0590 consolidated, Sept. 24, 2008, pp. 320-323)

Nicor Gas objects that Staff and intervenors do not show benefits of intra-day nominations. (Co. IB, pp. 91, 93) Nicor Gas does not explain how CNE would provide a quantifiable benefit when these benefits will accrue to customers not just of CNE but likely to all marketers and many larger and more sophisticated transportation customers. The Company criticizes Staff for no analysis but does not provide any of its own.

Nicor Gas argues that offering intra-day nominations will be costly. (Co. IB, p. 92) However, there is no estimate of how much this will cost.

Nicor Gas objects to Staff's request for some cost estimate because it lacked sufficient time due to the shortness of the surrebuttal round and Staff's late testimony. (Co IB, pp. 92-93) However, since CNE made its proposal in August (CNE 2.0, pp. 4-14), Nicor Gas had more than two months to support its objection based on costs made in its rebuttal testimony. (Co. Ex. 19.0, p. 31) The Company failed to provide support; therefore, the Commission should not reject CNE's proposal on these grounds. The fact that Nicor Gas failed to support its rebuttal claims should not be used as a basis for failure to support those claims later.

The Company is in a much better position to estimate its increased costs than Staff or Intervenors are to quantify the value of benefits to transportation customers or marketers trying to balance loads. CNE's listed benefits of intra-day nominations (CNE

2.0, pp. 11-13) remain unrefuted in the record. Thus, the record does support what some of those benefits will be, although no dollar value of those benefits is provided.

Staff's proposal is consistent with the Commission order from the Ameren case. In that Order, the Commission acknowledges the benefits of intra-day nominations even if Nicor Gas does not appreciate them.

> The Commission appreciates the benefits that more intra-day nomination cycles could bring to AIU's gas distribution systems and the customers thereof….In the meantime, the Commission approves of AIU's proposed 4:00 PM evening nomination cycle, in conjunction with its current Timely nomination cycle. The Commission also expects AIU to use its best efforts to try to accommodate any other off-cycle nominations it is able to using its current staff and resources, as it committed to doing.
> (Order, Docket No. 07-0585/07-0586/07-0587/07-0588/07-0589/07-0590 consolidated, p. 323, Sept. 24, 2008)

Similarly, Staff's proposal will allow for a significant increase in flexibility (from nothing to something) while protecting the Company from excessive fluctuations during the gas day.

CNE opines that Nicor Gas has reached a "compromise" from Mr. Bartlett's surrebuttal testimony. (CNE IB, pp. 37-38) However, Staff's understanding is that Nicor Gas has not offered this as its position but rather as an alternative if the Commission does implement an intra-day program.

Staff continues to recommend that the Commission order Nicor Gas to implement a pilot program to provide the evening nomination (6 PM) on a firm basis and the intra-day 1 nomination (10 AM) on a best-efforts basis to allow review of the effects and feasibility of this service.

5. Trading of Stored Gas

Nicor Gas argues that Staff's proposal to allow trading of gas by all transportation customers should be rejected. Its rationale is that the Company reached an agreement with VES to allow trading of stored gas only once annually and only for some Rider 25 customers. (Co. IB, p. 94) However, the Company never responded to Staff's concerns which are the basis for Staff's proposal to allow trading of gas by all transportation customers year round and not just the smallest customers once per year. (Staff IB, p. 125)

In Staff's view, the fact that the limited availability of trading of stored gas meets the needs of one Intervenor, in this case VES, does not legitimize its unavailability to the majority of transportation customers who are served under other transportation rates. Staff recommends that the Commission allow trading of gas by all of Nicor Gas' transportation customers as is allowed for Peoples Gas (Ill. C. C No. 28, Third Revised Sheet No. 68) and North Shore Gas (Ill. C. C No. 17, Second Revised Sheet No. 68) customers. (Staff IB, p. 125)

While VES states that all of its concerns are met in the agreement, Staff does not agree with the solution reached for reasons outlined in its Initial Brief. (Staff IB, p. 125) Staff also continues to recommend that the Commission reject the Nicor Gas' proposed, unsupported increase in the Excess Storage Bank Transfer fee and instead keep it at $15 per trade. (Staff IB, pp. 125-126)

6. Super-Pooling on Critical Days

Nicor Gas states that "the Company's proposal regarding the manual process to adjust charges under Rider 13 answers CNE's concerns." (Co. IB, p. 94)

However, CNE raises a concern that, in addition to the $6 per therm penalty, the price of gas that transportation customers have to pay for this unauthorized usage is a relatively-high, market price. Transportation customers must pay this high price even when their supplier has provided in net all of the gas required to serve its customers and Nicor Gas has had to purchase no gas for any of that suppliers' customers at any price. (CNE IB, p. 39) Nicor Gas' solution does not adequately address that portion of CNE's concern.

Therefore, Staff continues to recommend that the Commission order to expand Super-pooling to apply to penalties on Critical Days. Staff also recommends that the Commission approve the expansion of super-pooling to the requirements for the April 30 spring cycling target because the logic for doing so is identical to that already approved for the fall target of November 1. (Staff IB, pp. 126-127)

7. Seasonal Usage Maximum

Please see discussion above in Section VIII.C.5.b.

8. Other

X. Tariff Revisions Affecting Customer Select Customers

A. Overview

B. Uncontested Issues

1. Customer Select Balancing Charge ("CSBC")

2. Carrying Cost of Capital for Working Gas

3. Customer Select Administrative Fee

4. Access to Nicor Gas Assets

XI. Existing Riders

A. Rider 2 – Franchise Cost Adjustment

B. Rider 5 – Storage Service Cost Recovery

C. Rider 8 – Adjustments for Municipal and State Utility Taxes

XII. New Riders

A. Overview

B. Rider 26 – Uncollectible Expense Adjustment ("UEA")

The Company presents a number of arguments for its proposed Rider UEA, none of which provide any reasonable basis for its approval in this docket. The arguments are inherently flawed and should be rejected by the Commission.

Nicor Gas begins with a misleading argument about volatility which suggests the volatility of gas prices provides good reason to approve the Company's proposed rider for uncollectibles costs. The Company seeks to make the connection by stating "Gas prices have had a substantial negative impact on the Company's opportunity to recover its gas-related costs, as natural gas prices directly affect the level of the Company's Uncollectible Expense due to the close correlation between gas prices and Uncollectible Expense." (Co. IB, p. 100)

The problem with this argument is that unrebutted record evidence shows that uncollectibles costs are considerably less volatile than gas costs. (See Staff Ex. 7.0, pp. 9-11) Thus, gas cost volatility cannot be used as justification for an uncollectibles rider.

Nicor Gas continues its discussion of the volatility issue by taking issue with Staff's statement "that uncollectible expenses are not volatile in comparison to other system costs and, therefore, do not warrant rider recovery." Nicor Gas seeks to undermine this statement by citing Staff witness Brightwell's statement that natural gas prices are "very volatile." (Co. IB, pp. 102-103)

The Company's argument misses the mark once again. The statement by Mr. Brightwell pertains specifically to gas cost volatility and Nicor Gas already has a rider in place to recover gas costs. The issue at hand is whether significantly less volatile uncollectibles costs should be recovered through a rider as well. Any volatility arguments for Rider UEA should focus on uncollectibles costs only.

Nicor Gas also seeks to counter Staff's concerns that the proposed Rider UEA would undermine the Company's incentive to effectively manage its Uncollectible Expense. The Company insists that even with the rider it "is incented to expedite cash collections, and reduce the number of days between delivery of gas service and receipt of cash." (Co. IB, p. 103) This statement implies that the Company's cash-flow improves by recovering uncollectibles directly from the customers incurring the bad debts rather than from customers in good standing through Rider UEA. However, it is not clear why that should be true. Recovering revenues from delinquent customers can take time as those customers search for ways to pay their gas bills. Conversely, if the Company were able to flow uncollectibles through a rider, it would receive regular and full recovery of those costs. The rider approach would appear to provide the more effective means for recovery of uncollectiblles costs. Thus, the Company would have the incentive from a cash-flow standpoint to recover these costs through the rider.

The Company goes on to argue that "even if one were to believe incentives are required, the dead-band within which Nicor Gas is exposed provides a significant incentive to the Company to either avoid higher Uncollectible Expense or attain the benefit of a lower Uncollectible Expense." (Co. IB, p. 103) What the Company is saying is that it has the incentive to control uncollectibles costs within the deadband when the rider is not effective. There is no dispute on that point. The incentives problem arises outside the deadband when the rider comes into effect and allows a one-for-one recovery of these costs. The resulting disincentive to control uncollectibles can only be addressed by rejecting the rider. Only then will Nicor Gas have the proper incentive to control uncollectibles costs.

C. Rider 27 – Company Use Adjustment

The Company depicts three concerns from Staff's testimony along with three concerns from AG/CUB testimony and argues that Company testimony shows these concerns are without merit. The Staff concerns that the Company attempts to address are (1) whether natural gas price volatility causes Company use gas costs to rise to a level that justifies rider recovery; (2) whether lost and unaccounted for gas storage losses are being measured properly and whether any incorrect measurement leads to improper financial accounting; and (3) whether the rider would adversely affect the Company's incentives to conserve gas. (Co. IB, p. 107)

However, despite its contentions, the Company fails to refute Staff's concerns. In its Initial Brief, Staff shows why these three concerns have merit and also addresses the issue of whether it is appropriate or necessary to recover the costs recorded in Uniform System of Accounts account 823 through a rider. (Staff IB, pp. 146-152) Due to the merits of Staff's concerns and the Company's failure to adequately address these concerns, Staff recommends that the Commission reject Rider CUA.

D. Rider 28 – Volume Balancing Adjustment

The Commission has expressed interest in evaluating different ways of providing gas utilities the opportunity to recover fixed costs. (Commission Order Docket No. 07-0585 et al. (Cons.), pp. 236-238, September 24, 2008) The Commission has previously approved two different approaches for evaluation. For Peoples Gas and North Shore Gas, the Commission approved a partial decoupling rider that allows the Companies to recover their fixed costs on a per customer basis. (Commission Order Docket Nos. 07-0241/07-0242 (Cons.) pp. 150-153, February 5, 2008) For the Ameren Illinois Utilities, the Commission modified the monthly customer charge to recover more of the fixed delivery services costs through the customer charge. (Commission Order Docket No. 07-0585 et al. (Cons.), p. 237, September 24, 2008) The record in this proceeding provides the Commission with two different options for addressing fixed costs. The first option, which was proposed by Nicor Gas, is a partial decoupling Rider VBA similar to the rider approved for Peoples Gas and North Shore Gas. The second option is the full decoupling Rider VBA identified by Staff. This option represents a new approach that the Commission has not yet considered. Staff makes no recommendation regarding which form of Rider VBA is the more appropriate mechanism for the recovery of the Company's fixed delivery service costs. Staff offers the full decoupling Rider VBA as an alternative way of providing gas utilities the opportunity to recover fixed costs that the Commission could approve and evaluate should it wish to do so.

The first option is the partial decoupling Rider VBA proposed by the Company with Staff-proposed revisions that the Company has accepted. (Co. IB, p. 111) Under this option, which is tied to rate case margin per customer, the Company could recover more or less than the total fixed costs approved in a rate proceeding, depending upon how the actual customer base fluctuates in comparison to the customer base assumed in the rate case. (Staff IB, pp. 152-155) This approach is similar to the one the Commission approved for Peoples Gas and North Shore Gas.

The second option is the full decoupling Rider VBA identified by Staff. The Company opposes this alternative. (Co. IB, p. 111) As explained more fully in Staff's initial brief, a full decoupling Rider VBA would allow the Company to recover only the total amount of fixed costs approved in a rate proceeding rather than the fixed costs on a per customer basis as proposed by the Company. Staff makes no recommendation regarding which form of Rider VBA is the appropriate mechanism for the recovery of the

Company's fixed delivery service costs. The full decoupling Rider VBA identified by Staff is offered to the Commission simply as an alternative it may wish to consider should it decide to approve another Rider VBA pilot program. (Staff IB, pp. 152-155)

E. Rider 29 – Energy Efficiency Plan

Response to the Company, AG, and ELPC about the merits of an Energy Efficiency Plan and the Proposed Management Structure

Staff recommends that the Commission reject Rider EEP and the Company's proposed Energy Efficiency Plan pilot. The Company, the AG and ELPC each argue that the EEP should be approved. In their respective arguments, each of these parties cite 220 ILCS 5/12-103(a) and the Final Order in Docket No. 04-0779 to show that both the General Assembly and the Commission support energy efficiency as a socially desirable goal that will reduce direct costs to consumers. (ELPC IB, p. 2; AG IB, p. 71; Co. IB, pp. 112-113)

However, none of these parties fully and accurately quote either the Commission Order or the General Assembly in their respective citations. 220 ILCS 5/12-103(a) is related to electric utilities. The section begins "[i]t is the policy of the State that electric utilities are required to use cost-effective energy efficiency and demand-response measures to reduce delivery load." There is no mention of natural gas utilities in 220 ILCS 5/12-103. In fact, the Company's proposal fails to even meet the definition of energy efficiency set forth by the General Assembly. The passage quoted by each of these parties clearly states that energy efficiency shall have the meaning set forth in the Illinois Power Agency Act ("IPAA"). The IPAA defines energy efficiency as "measures that reduce the amount of electricity required to achieve a given end use." (20 ILCS 3855/1-10)

In the Final Order of Docket 04-0779, the Commission stated that even if the ELPC had standing to propose an EEP, it had not met its burden of proof because

> the record in the instant case contains little more than vague ideas for incentives for more efficient furnaces, water heaters, windows, and insulation. At present, many basic questions remain. For example, what products qualify? How large should the incentives be? Which rate classes may receive incentive credits? Should all rate classes fund the program, or only some? Who administers the program and is accountable for the funds?
> (Docket No. 04-0779 Final Order, p. 192, Sept. 20, 2005)

The EEP proposed by the Company addresses the issues of which rate classes are eligible for the program, which rate classes fund the program, and who administers the program, but still fails to state which products qualify and how large the incentives are. It also gives little more than vague ideas for incentives for more efficient furnaces, water heaters, windows, and insulation. Frighteningly, the answer to who is accountable for the funds seems to be an unspecified group that has not yet been determined, whose qualifications are unknown and who is not directly accountable to the Commission for the prudence of its financial decisions. (See Co. Ex. 13.0, pp. 6-7; Staff Ex. 13.0, pp 15-16)

The lack of fiscal accountability of the proposed Advisory Board, the lack of knowledge about the qualifications of potential Advisory Board members, and the possible subversion of this Board’s authority by the pilot nature of this EEP causes Staff to recommend that, if the Commission approves an EEP, it should change the management structure so that Nicor Gas is clearly responsible for the portfolio of projects. (Staff Ex. 13.0, pp. 15-16)

The Company argues Staff’s proposed change in management structure is not appropriate because, under Nicor Gas’ proposed structure, the “roles and responsibilities of the Advisory Board were designed to put the decisions of what portfolio of programs would best serve the Nicor Gas customers into the hands of a qualified, experienced and *independent Board.*" (Co. IB, p. 116) The AG makes a similar argument (AG IB, p. 74) and ELPC states that the Company's proposed structure is preferable because the Company has no experience running programs of this type. (ELPC IB, p. 5)

Unfortunately, all of these endorsements of the Company's proposed structure hinge on the assumption that an Advisory Board will be comprised of experienced experts in the field of energy efficiency implementation and program management. ELPC states that members are likely to be representatives from the AG's Office, CUB, and ELPC. (ELPC IB, p. 6) While members of these organizations are intelligent and diligent in their areas of expertise, their primary duties are not comprised of energy efficiency implementation and program management and their experience in this area is very limited.

Mr. Kubert, who was the ELPC representative on the Peoples Gas Operating Committee, testified that he left the ELPC. (Tr., p. 135, Nov. 17, 2008) He also testified that prior to his involvement on the Peoples Gas Operating Committee, he had no management experience in energy efficiency programs (*Id.*, p. 144) and that ELPC hired an outside consultant to represent it in the ComEd/Ameren Stakeholder Advisory Group meetings because "No one on the ELPC staff has such grave experience in administering these programs." (*Id.*, p. 147)

No party has established that an external Advisory Board is competent to manage this program. The Company, ELPC and AG all concede that the Commission is limited to disbanding the program or refunding to ratepayers only unspent EEP funds, leaving the Commission no authority to order any imprudently spent funds to be returned to ratepayers. (Co. Ex. 47, p. 9; AG IB, p. 74; ELPC IB, p. 5) As a result, Staff recommends that either the management structure should be changed so that the Commission has the authority to fully protect ratepayers or that the EEP should be rejected because the Company has not provided evidence that its proposed Advisory Board has the experience to cost-effectively manage the EEP.

Response to the Company about the Conservation Stabilization Adjustment ("CSA")

Staff recommends that the CSA clause of Rider EEP be removed. The CSA is problematic because it uses ex-ante deemed estimates of therm savings and free riders to assess the program-induced revenue losses to the Company. It also seeks to recover losses from market transformations which are difficult, if not impossible, to accurately assess. (See Staff IB, pp. 161-163)

The Company asserts that Rider EEP should include a CSA recovery mechanism if Rider VBA is not approved. (Co. IB, p. 118) It argues that there would be no distortions in the calculated savings because the "experts" on the Advisory Board would insure the accuracy of the calculations, and findings from ex-post evaluations of projects would be used for future project evaluations. (*Id.*, p. 119)

Staff has already presented evidence to suggest that the Advisory Board's expertise is perhaps overstated, and Mr. O'Connor testified that these ex-post evaluations are not intended to refund to or recover from ratepayers any lost revenues that were inaccurately deemed. All deeming of program-induced lost revenues for the purposes of the CSA clause are intended to be conducted on a prospective basis. (Tr., p. 106, Nov. 17, 2008)

Proposed Language Changes

Although Staff recommends that Rider EEP be rejected by the Commission, Staff has proposed changes to the language in Rider EEP in the event the Commission determines the rider is appropriate. (Staff Ex. 3.0, pp. 31-32) The Company has agreed to accept Staff's proposed changes. (Co. IB, p. 115) Similarly, Staff has agreed to accept two modifications to the language in the rider that were proposed by the Company. (Staff Ex. 16.0, pp. 14-15)

F. Rider 30 – Qualifying Infrastructure Plant

Nicor Gas offers little reason in its Initial Brief for the Commission to adopt the proposed Rider QIP. The Company limits its argument to presenting a perfunctory set of statistics that seek to show why cast iron mains and copper services need to be replaced. Nicor Gas notes that the "leak rate per mile for cast iron main is 11.21 times higher, or 1,020% higher, than for other materials" and the "leak rate for copper services is 4.77 times higher, or 377% higher" than for other services. (Co. IB, p. 124) Somehow, the Company believes, this should be construed as an iron-clad argument for approving the proposed Rider QIP.

The Company's discussion only serves to raise further questions about the proposed rider. For one, it is not clear why the only concrete savings Nicor Gas could guarantee for ratepayers from its replacement program is $6,000 per mile of replacement given these higher leak rates for cast iron mains and copper services. (*Id.*) And it is still not evident why ratepayers would want the Company to undertake the replacement program when their $6,000 per mile of savings is countered by an estimated $416,761 cost per mile to replace those mains. (Staff Ex. 20, p. 9)

Its Initial Brief also fails to explain why the Company should receive extraordinary recovery through the rider of costs to provide ordinary gas service to its customers. The accelerated main replacement program will not provide any new or enhanced service to ratepayers. Rather, it will facilitate the continued provision of basic gas service which is a statutory obligation for Nicor Gas. If an accelerated program is needed to provide safe and reliable service at minimum cost, the Company should not be rewarded through a rider that provides for recovery of incremental plant costs between rate cases. (Staff Ex. 7.0, pp. 17-18)

XIII. Terms and Conditions
A. Proposed Changes
B. Uncontested Issues
C. Contested Issues
Non-Sufficient Funds ("NSF")
XIV. Revenues
A. Total Billing Units / Rate 4 and Rate 74 Billing Units
B. Nicor Energy Services Billing Adjustment

Nicor Gas contends that its billing rate to Nicor Services is proper since the Commission-approved Operating Agreement provides that an affiliate be charged fully distributed costs if the utility does not offer that exact specific service to the public. (Co. IB, p. 132-133) Section 7-103(3) of the Act provides the Commission discretion, however, in setting rates based upon charges originated through affiliate interest agreements; the language of Nicor Gas' Operating Agreement is not controlling in the instant proceeding. (Staff IB, pp. 175-176, citing Ameren Order)

Further, the record is clear that the Company is providing billing services to two different affiliates, but at different rates. (*Id*., p. 131) The Company's attempt to draw distinctions between the two products that Nicor Services and Nicor Solutions sell (Co. IB, pp. 131-132) does not demonstrate why the billing services provided to these two companies for two different products would cause one affiliate to receive a rate over double the rate received by the other affiliate. The AG supports Staff's adjustment. (AG IB, p. 98) Staff's adjustment appropriately imputes revenues to Nicor Gas for services provided to Nicor Services and should be adopted by the Commission.

XV. Gross Revenue Conversion Factor

XVI. Other Issues

A. Accounting for Storage Gas Losses

Nicor Gas claimed "Accounting for Storage Losses" as an uncontested issue. (Co. IB, p. 133) However, Nicor Gas in its Initial Brief does not fully accept Staff's position and has failed to clearly state a position on this issue. Staff's position is that a 2% Storage Adjustment Factor for all storage withdrawals from Company storage fields is inappropriate and should be discontinued. Nicor Gas should discontinue the use of the blanket 2% loss factor for storage adjustments; instead, the Company should estimate the "physical losses" as they occur at each storage field and should determine its "performance variation" volumes via the Company's Inventory Verification Studies ("IVS") only when precise measurement permits reliable results. Nicor Gas should work with Staff to formulate written procedures that address Staff's concerns. (See Staff IB, pp. 177-190) Rather than directly accepting Staff's recommendations, Nicor Gas requests a transition period until new procedures are in place. (Co. IB, pp. 133 – 134) Nicor Gas appears to continue to support the 2% adjustment factor (*Id*.), and as Staff understands the "revised approach" offered by the Company, it would not eliminate the use of the 2% adjustment factor. To the extent that Nicor Gas has not agreed to discontinue any reliance of the 2% adjustment factor in calculating withdrawals from Company storage fields, Staff does not consider this as an "uncontested issue".

Staff recommends that the Commission direct Nicor Gas to discontinue its use of a 2% storage adjustment factor for all withdrawals from its storage fields. Instead, the Commission should direct Nicor Gas to differentiate between the two types of gas losses by estimating physical losses as they occur and reducing injected volumes to reflect estimated physical losses and to use its Inventory Verification Studies "IVS" studies to determine the appropriate level of performance variations when precise measurement permits reliable results. In addition, Staff recommends the Commission direct Nicor Gas to work with Staff to formulate a written policy to ensure the appropriate procedures are in place regarding underground storage adjustments or corrections and that the written policy should specify the proper accounting treatment based on the type of gas losses. The Commission should direct Nicor Gas to provide the Director of the Energy Division and the ICC's Accounting Department with a copy of these written procedures within 60 days after a final Order is entered in this proceeding.

B. Reporting of Affiliate Transactions

The Company accepted Staff's recommendation for annual reporting of its affiliated interest transactions as a supplemental page to its Form 21. (Staff Ex. 2.0, pp. 35-36 and Staff Ex. 15.0, p. 18) Accordingly, Staff recommends the Commission order to include finding and ordering paragraphs directing Nicor Gas, beginning May 1st 2009 for the 2008 reporting period, to file a Supplemental Schedule to From 21 reporting the amount paid each year to each affiliate and the amount received each year from each affiliate. The Supplemental Schedule shall also provide a description of the services provided or received, and a description of the method used to determine the amount of the charges.

C. Operating Agreement

XVII. Conclusion

WHEREFORE, for all of the following reasons, Staff respectfully requests that the Commission's order in this proceeding reflect all of Staff's recommendations regarding the Company's request for a general increase in gas rates.

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Respectfully submitted,

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