STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Northern Illinois Gas Company d/b/a Nicor Gas Company (Tariffs filed April 29, 2008)	:	
	:	**08-0363**
Proposed general increase in rates, and revisions to other terms and conditions of service.	:	

ORDER

Dated: March 25, 2009

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By the Commission:

I. INTRODUCTION

A. PROCEDURAL HISTORY

On April 29, 2008, Northern Illinois Gas Company, doing business as Nicor Gas Company ("Nicor Gas" or the "Company"), filed with the Illinois Commerce Commission (the "Commission") pursuant to Section 9-201 of the Public Utilities Act (the "Act"), 220 ILCS 5/9-201, the following tariff sheets: Ill. C. C. No. 16, 17th Revised Sheet No. 1; 1st Revised Sheet No. 1.5; 4th Revised Sheet Nos. 3 through 9; 5th Revised Sheet Nos. 10 and 11; 2nd Revised Sheet No. 11.5; 5th Revised Sheet Nos. 12 and 13; 2nd Revised Sheet No. 14; 6th Revised Sheet No. 18; 5th Revised Sheet No. 19; 6th Revised Sheet No. 21; 2nd Revised Sheet No. 21.4; 1st Revised Sheet No. 21.6; 7th Revised Sheet No. 22; 6th Revised Sheet No. 24; 7th Revised Sheet No. 25; 5th Revised Sheet Nos. 26 and 27; 6th Revised Sheet No. 28; 5th Revised Sheet No. 33; 4th Revised Sheet No. 34; 2nd Revised Sheet No. 35.5; 3rd Revised Sheet No. 38; 7th Revised Sheet No. 39; 6th Revised Sheet No. 41; 2nd Revised Sheet No. 42; 5th Revised Sheet No. 46; 8th Revised Sheet No. 48; 6th Revised Sheet Nos. 49 and 50; 2nd Revised Sheet No. 50.1; 7th Revised Sheet No. 52; 4th Revised Sheet No 52.2; 7th Revised Sheet No. 54; 1st Revised Sheet Nos. 55.51 through 55.54; 2nd Revised Sheet No. 55.55; 1st Revised Sheet Nos. 55.56 and 55.57; 4th Revised Sheet Nos. 56 and 57; 5th Revised Sheet No. 64; Original Sheet No. 64.1; 3rd Revised Sheet No. 64.5; 5th Revised Sheet No. 71; 4th Revised Sheet No. 72; 11th Revised Sheet No. 75.1; 8th Revised Sheet No. 75.5; 6th Revised Sheet Nos. 76 and 77; 5th Revised Sheet No. 78; 1st Revised Sheet No. 79; Original Sheet Nos. 79.1 through 79.3; 1st Revised Sheet No. 80; Original Sheet Nos. 80.1 through 80.3; 1st Revised Sheet No. 81; Original Sheet Nos. 81.1 through 81.3; 1st Revised Sheet No. 82; Original Sheet Nos. 82.1 through 82.3; 1st Revised Sheet No. 83; Original Sheet Nos. 83.1 through 83.4. Nicor also proposed to add five new Riders.

This rate filing embodied a general increase in rates for natural gas service as well as other proposed changes in terms and conditions. Notice of the proposed changes reflected in this rate filing was posted in Nicor Gas' business offices and published in a newspaper of general circulation in Nicor Gas' service area, as evidenced by publisher's certificates, in accordance with the requirements of Section 9-201(a) of the Act, 220 ILCS 5/9-201(a), and the provisions of 83 Ill. Adm. Code Part 255. The Commission issued an Order on June 4, 2008 suspending the tariffs up to and including September 25, 2008, and initiating this proceeding. Subsequently, the Commission re-suspended the tariffs on September 25, 2008 up to and including March 25, 2009.

Leave to Intervene was granted to the following entities: the People of the State of Illinois (the "Attorney General" or the "AG"); Citizens Utility Board ("CUB"); Constellation NewEnergy – Gas Division, LLC ("CNE-Gas" or "CNE"); Dominion Retail, Inc. d/b/a Prairie State Electric and Gas Corporation ("Dominion"); Environmental Law & Policy Center (the "ELPC"); Integrys Energy Services, Inc. ("Integrys"); Interstate Gas Supply of Illinois, Inc. ("IGS"); Local 19, International Brotherhood of Electrical Works, AFL-CIO ("Union"); Vanguard Energy Services, LLC ("Vanguard"); and collectively: Cargill, Inc., Caterpillar Inc., ArcelorMittal USA, BP Amoco Corporation, U.S. Silica Company, and ExxonMobil Gas & Power Marketing Company (the "Illinois Industrial Energy Consumers" or "the IIEC"). A Petition seeking leave to Intervene filed on behalf of Progressive Energy Group, LLC was denied. A Petition seeking leave to Intervene was filed on behalf of the Coalition for Equal Access and Fair Rates, but this party subsequently withdrew from the case.

On November 7, 2008, the parties and Commission Staff filed pre-hearing memoranda, in which they set forth the legal and factual issues that they would present at trial, thus satisfying the Constitutional requisite that notice of the legal and factual issues be presented before trial on those issues. Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter was heard by duly authorized Administrative Law Judges ("ALJs") at the offices of the Commission in Chicago, Illinois. An evidentiary hearing (hereinafter referred to as "trial") was held from November 17-19, 2008. At the evidentiary hearings, Nicor Gas, Staff of the Commission, the AG, CNE-Gas, CUB, Dominion, ELPC, IIEC, IGS, and Vanguard appeared and presented testimony. The Commission conducted a public hearing on February 24, 2009.

The following witnesses testified on behalf of Nicor: Richard L. Hawley, CPA, Executive Vice President and Chief Financial Officer; Rocco J. D'Alessandro, Executive Vice President of Operations; Gary R. Bartlett, Vice President of Supply Operations; Anthony R. McCain, Vice President of Field Operations; Kevin W. Kirby, Vice President of Customer Care; Rebecca C. Bacidore, Assistant Vice President of Human Resources; Douglas M. Ruschau, Vice President and Treasurer; James M. Gorenz, CPA, Assistant Controller; Gerald P. O'Connor, FCCA (Chartered Certified Accountant in Ireland and the United Kingdom), Senior Vice President of Finance and Strategic Planning; Kristine J. Nichols, Vice President of Engineering; Robert R. Mudra, CFA, Director of Rates and Financial Analysis; Karen K. Pepping, CPA, MBA, Vice President and Controller; Steven M. Fetter, President of Regulation UnFettered; Michael J. Adams, Vice President of Concentric Energy Advisors, Inc.; Jeff D. Makholm, Ph.D., Senior Vice President of National Economic Research Associates, Inc.; and Alan C. Heintz, Vice President of Brown, Williams, Moorhead & Quinn, Inc.

The following witnesses testified on behalf of Staff: Daniel G. Kahle, an Accountant in the Accounting Department of the Financial Analysis Division; Dianna Hathhorn, an Accountant in Accounting Department of the Financial Analysis Division; Burma C. Jones, an Accountant in Accounting Department of the Financial Analysis Division; Mike Ostrander, an Accountant in Accounting Department of the Financial Analysis Division; Janis Freetly, a Senior Financial Analyst in Finance Department of the Financial Analysis Division; Sheena Kight-Garlisch, a Senior Financial Analyst in the Finance Department of the Financial Analysis Division; Peter Lazare, a Senior Economic Analyst in the Rates Department of the Financial Analysis Division; Christopher L. Boggs, a Rate Analyst in the Rates Department of the Financial Analysis Division; Dennis L. Anderson, a Senior Energy Engineer in Gas Section of the Engineering Department of the Energy Division; Mark Maple, a Senior Gas Engineer in the Engineering Department of the Energy Division; David Sackett, an Economic Analyst in the Policy Program of the Energy Division; Bill L. Voss, a Technical Analyst in the Financial Analysis Division; and David Brightwell, an Economic Analyst in the Policy Program of the Energy Division.

The AG and CUB presented joint witnesses David J. Effron, a regulatory consultant specializing in utility regulation, and Scott J. Rubin, an independent consultant. CUB presented an additional witness, Christopher C. Thomas, the Director of Policy at CUB.

The following witnesses testified on behalf of CNE: Darcy A. Fabrizius, Manager of Regulatory Affairs for CNE-Gas, and Lisa A. Rozumialski, Manager of Gas Operations for CNE-Gas. IGS and Dominion (collectively “the Customer Select Gas Suppliers” or “CSGS”) presented James L. Crist, President of Lumen Group. The ELPC presented witness Charles Kubert, a Senior Environmental Business Specialist at ELPC. The IIEC presented Dr. Alan Rosenberg, a managing principal with Brubaker & Associates, Inc. Vanguard presented its witness Neil Anderson, a partner with Vanguard.

B. NATURE OF OPERATIONS

Nicor provides natural gas service to customers in a service territory of approximately 17,000 square miles, which includes much of north and north-central Illinois. It serves approximately 2.2 million customers. Nicor provides sales service (service that involves both the transportation of gas to the end-user and the sale of gas itself) and transportation service (service that principally involves the movement and delivery of gas and, only incidentally if at all, the sale of gas itself). To serve those customers and provide those services, Nicor operates and maintains eight aquifer gas storage fields. It also operates a system of natural gas distribution and transmission assets that allow it to take gas delivery from interstate pipelines, move Company-owned or customer-owned gas to and from its storage fields, move gas between and within the major areas of its service territory, control gas flows, and reduce gas pressure so that gas flows through local distribution gas mains and pipes.

Nicor's last rate increase occurred in 2005, Docket 04-0779. In the final Order in that docket, for the test year ending December 31, 2005, the Commission approved a rate base in the amount of $1,166,611,000, a rate of return of 8.85%, which represents a return on common equity of 10.51%, a return on long-term debt of 6.72% and a return on preferred equity of 4.77%., with base rate revenues of $549,689,000, which represented a gross increase of $45,581,000 or 8.73%. (*Northern Illinois Gas Company, Proposed General Increase in Rates,* No. 04-0779, (the "Nicor Rate Order") Order of September 20, 2005, at 195-95).

In this docket, Nicor seeks an increase in its base rate revenue requirement in the amount of $140,399,000 to recover the test year deficiency. This amount, unadjusted, approximately represents an increase of approximately 5% to an average residential customer's total annual bill. Nicor's request, unadjusted, would result in an increase of approximately $4.62 per month for an average residential customer, or $55.48 per year.

II. OVERALL REVENUE REQUIREMENT AND THE REVENUE DEFICIENCY

Nicor calculated its test year rate base using an average of the rate base at the beginning and end of the test year, consistent with the Commission's determination in Nicor's last rate case, Docket 04-0779. No party contested Nicor's use of an average test year rate base. Based upon certain adjustments to rate base made during the course of this proceeding, Nicor now is proposing a test year rate base of $1,515,726,000. A number of rate base issues were resolved and are identified below. Staff and AG/CUB each propose certain adjustments to the Company's rate base. These contested issues also are addressed herein.

Nicor averred that its test year overall base rate revenue requirement is $687,679,000, but, it will recover only $547,280,000 pursuant to its current rates. Nicor proposes a rate increase of $140,399,000 in order to recover the test year revenue deficiency. No party has contested Nicor's assertion that it is experiencing a revenue deficiency.

III. THE TEST YEAR

Nicor proposed to use a forecasted 2009 test year. No party objected to the proposed test year.

IV. RATE BASE

A. OVERVIEW

Rate base is the net level of investment that a utility company has dedicated to public service, on which it is entitled to earn a return. Generally, rate base consists of book investment in plant, and working capital, less deductions that reflect other sources of funds.

Nicor calculated its test year rate base using an average of the rate base at the beginning and end of the test year. Nicor Ex. 11.0 at 12. No party has contested Nicor's use of an average test year rate base. Based upon adjustments to rate base made during the course of this proceeding, Nicor is now proposing a test year rate base of $1,515,726,000. Nicor Initial Brief at 9.

B. UNCONTESTED ISSUES

1. The Northern Region Reporting Center

Nicor seeks to include the cost of building a new Northern Region Reporting Center (the "NRRC") in its test year rate base. The estimated cost of the NRRC is $12,500,000. However, Nicor only seeks to include $5,933,000 in rate base in this proceeding, but, it reserves its right to adjust the cost of the NRRC in a future rate case. Nicor Initial Brief at 10. Staff supports Nicor's position. Staff Initial Brief at 3. Based upon the evidence, we conclude that inclusion of $5,933,000 is reasonable. It is hereby approved.

2. Plant Additions-The Original Cost Determination

In the course of examining Nicor's rate base, Staff audited plant additions for the period of time from 2004 through 2007. Staff reviewed Nicor's invoices, which were selected through a statistical sampling method. Staff determined that no adjustment to historical plant additions is warranted. Staff recommended that this Commission approve Nicor's December 31, 2007 plant balances, as is reflected in Nicor's Schedule B-5, Column (L), for purposes of original cost determination, subject to any Commission-ordered adjustments. Staff Initial Brief at 4, 7. Based upon the evidence of record, we conclude that Nicor's December 31, 2007 plant balances reflected in Schedule B-5, Column (L) are approved for the purpose of determining an original cost determination.

C. CONTESTED ISSUES

1. Cash Working Capital

Cash Working Capital ("CWC") is the amount of funds required on a permanent basis to finance the day-to-day operations of the Company. CWC is best defined as a cash advance from investors. For example, if the flow of cash in and out of the utility's coffers is imperfectly balanced, and the utility requires immediate funds to pay expenses as they become due, investors finance the shortfall.[1] A positive CWC requirement means that the Company's shareholders are providing the necessary funds to maintain operations at current levels. A negative CWC requirement indicates that the Company's customers are providing the necessary funds to manage the day-to-day operations of the Company. The CWC requirement is added to rate base if shareholders are providing funds or are subtracted from rate base if the Company's customers are providing funds.

The calculation of Nicor's CWC requirement was based upon the results of a lead-lag study. A lead-lag study measures the timing differences between the receipt of funds from a utility's customers for services provided and the payment for goods and services received by the Company. Nicor presented its CWC requirement using both

[1] Peoples Gas Light & Coke Co. ("The 2007 Peoples Gas Rate Case"), Docket No. 07-0241, Order at 17 (Feb. 5, 2008).

the Net Lag and Gross Lag Methodologies. Nicor noted that the CWC requirement under the Net Lag and the Gross Lag Methodologies appropriately produced identical results. It relied on this methodology in determining the CWC requirement since it recognized that this practice was approved by the Commission twice last year.[2] In support of its position, Nicor presented the testimony of Michael J. Adams, who ultimately determined that Nicor's proposal should include a CWC requirement of $87,544,000 as part of its test year base.

Staff, on the other hand, proposed to reduce the amount of CWC that was added to rate base for pass-through taxes because pass-through taxes represent funds provided by ratepayers rather than investors. Staff presented the testimony of Mr. Kahle, who recommended that the Commission adopt zero revenue lag days for pass-through taxes. Staff argued against Nicor's position that pass-through taxes collected from the ratepayers should be treated as operating revenue and expenses to the Company.

a. Inclusion of Pass-Through Taxes at Zero Revenue Lag Days

i. Nicor's Position

The Company maintained the proper method for determining the appropriate number of revenue lag days for pass-through taxes should be based upon the timing of the revenues associated with the pass-through taxes. In this regard, Nicor argued that the only source for collecting these taxes funds is through customer billing. It disagreed with Staff's claim that Nicor did not provide a service that could be tied to pass-through taxes. It argued that since the fact remains that the customers are billed for pass-through taxes on their bills, it is part of the cumulative costs to the ratepayers for gas service and should be included as operating revenue and an operating expense in the CWC analysis.

Nicor cited to two recent Commission Orders to support its position. First, in the 2007 Peoples Gas Rate Case, the Commission rejected Staff's identical proposal, stating:

> Regarding Staff's first argument – that there is no revenue lag for pass-through taxes – Staff's apparent concern is that pass-through taxes provide no service to the customer and involve no product or service costs (other than tax collection costs, which are presumably recovered as O&M expenses). Moreover, several of the taxes are paid quarterly or annually, which raises the question of how, in common sense, they can have a revenue lag. That said, however, the Utilities still must obtain revenue to remit to the taxing bodies, and the only revenue collection mechanism in the record, with its attendant revenue lag, is the monthly bill.

[2] *2007 Peoples Gas Rate Case*, Order at 22; *Ameren Utilities ("2007 Ameren Rate Case")*, Docket No. 07-0586, Order at 62 (Sept. 24, 2008).

> Consequently, while the Commission would welcome additional analysis, as Staff suggests, addressing the movement of pass-through taxes in and out of the Utilities' accounts for CWC purposes, we do not have that analysis here. For now, we will include pass-through taxes in the revenue portion of the gross lag study approved in these dockets.

2007 Peoples Rate Case Order at 22. Next, in the 2007 Ameren Rate Case, Commission once again rejected Staff's proposed adjustment:

> The Commission has reviewed the arguments and, in the context of a CWC requirement, the Commission is unable to discern a meaningful difference between pass-through taxes and most other expenses. Customers pay their bills, including pass-through taxes, providing AIU with cash. AIU makes cash payments, including pass-through taxes, to those entities that have a rightful claim. Again, in the context of CWC requirement, pass-through taxes are no different than State or Federal income taxes or employee payroll expense. The Commission therefore concludes that Staff's proposed adjustment to the CWC requirement associated with pass-through taxes is inappropriate and is hereby rejected.

2007 Ameren Rate Case, Order at 62.

Nicor argued that Staff failed to present new information because there is only one source of revenue (including revenue for pass-through taxes) through which the Company receives payment from its customers—the payment of the customers' bills. It asserted that pass-through taxes and all other operating revenues are collected in the same manner and at the same time, thus there is no alternate vehicle by which pass-through taxes are collected. As such, it argued that pass-through taxes should be included in the CWC analysis at the same level of revenue lag days as all other revenues, which is 50.81 days.

Nicor further argued that its CWC analysis reflects the actual elapsed time between the collection of the customers' payments and the remittance of the pass-through taxes to the appropriate taxing authority. The Company contended that Staff's position is based upon an unsubstantiated belief that Nicor collects funds, via an unidentified source or process, and then withholds the funds earmarked for pass-through taxes in excess of a month prior to remitting the funds to the appropriate taxing authority.

Nicor maintained that Staff's proposal to assign zero revenue lag days for pass-through taxes suffers from several flaws. Nicor contended that Staff improperly concluded that pass-through taxes were not recorded by the Company as operating revenues. However, according to Nicor, the evidence shows that the Company does record pass-through taxes as operating revenues and operating expenses. Nicor also averred that Staff confused the Company's treatment of the pass-through taxes for accounting purposes with its treatment for ratemaking purposes. It cited to evidence that showed that it appropriately excluded pass-through taxes, via a pro forma ratemaking adjustment, from operating revenues and expenses for purposes of calculating its revenue requirement.

Nicor also stated that Staff incorrectly presumed that pass-through taxes are not related to the provisioning of a service. Here, Nicor argued, it is clear that such taxes are directly related to the provision of a service—pass-through taxes are the direct result of customers' consumption of natural gas. Thus, it contended that both the service being provided and pass-through taxes are integrally linked.

Nicor further argued that Staff's position failed to consider that the Company bears the burden of the Illinois Public Utility Tax, the Illinois Gas Revenue Tax and municipal gas receipts taxes, as it is statutorily liable for these taxes and is allowed to recover the expense of these taxes from customers through the ratemaking process, similar to any other expense. By statute, the Company must collect the Illinois Gas Use Tax, where applicable, from its customers and remit such tax to the State of Illinois. To the extent that Nicor fails to collect and remit such tax, it becomes principally liable to the taxing jurisdiction. As such, Nicor stated that it is much more than merely a collection agency for the taxing jurisdiction.

Finally, the Company argued that Staff has presented no evidence to justify a reversal of the Commission's previously-stated position. Nicor asserted that here simply is no reasonable basis, and Staff offered none, for the Commission to reverse course from its recent rulings on this issue.

ii. Staff's Position

Staff proposed to reduce the amount of CWC added to rate base for pass-through taxes because pass-through taxes represent funds provided by ratepayers rather than investors. Staff proposed to do this by applying revenue lag days of zero to pass-through taxes in the CWC calculation because 1) in the context of a rate case, pass-through taxes are not operating revenue, and therefore cannot have a revenue lag; and 2) ratepayers provide pass-through taxes for the Company to hold and later remit to taxing bodies. Through the CWC requirement, investors would rightly receive a return on their financing of operating expenses which would produce operating revenue, if there is a lag in operating revenue that covered operating expenses. However, with respect to pass-through taxes, Staff argued that investors have not invested funds to finance operations. If a revenue lag for pass-through taxes is included in the CWC requirement and added to rate base, investors will earn a return on ratepayer-supplied funds. Staff recommended a reduction of CWC, and therefore rate base, of $25,010,000. Staff Ex. 1 at 8-11.

Staff maintained that the Commission should adopt zero revenue lag days for pass-through taxes and reject Nicor's argument that pass-through taxes represent operating revenue to Nicor. Staff stated that the Commission should not allow Nicor to increase its rate base for revenue lag on funds for pass-through taxes because funds for pass-through taxes are provided by ratepayers.

Staff contended that Mr. Kahle's testimony proves that pass-through taxes are not revenue in the context of a rate case. This is the basis for Mr. Kahle's adoption of zero revenue lag days for pass-through taxes. Staff points to the Company's own adjustment to eliminate pass-through taxes from operating revenue as confirmation that pass-through taxes are not revenue in the context of a rate case.

Staff maintained that the surrebuttal testimony of Nicor witness Mr. Adams attempted to confuse this point by discussing the recording of pass-through taxes for financial reporting purposes, rather than the treatment of pass-through taxes in this rate case. The Company may have many types of cash receipts recorded for financial reporting purposes that are not considered as operating revenue in a revenue requirement.

Staff argued that Nicor is wrong when claiming that Mr. Kahle erroneously concluded pass-through taxes are not recorded as operating revenues for financial reporting purposes. In fact, Staff believed that all of Mr. Kahle's references to pass-through taxes not being earmarked as revenue have been related to the operating revenue considered in this rate case. Staff maintained that pass-through taxes are not operating revenue in the revenue requirement. Staff argued that its theory was confirmed by Nicor's adjustment to eliminate pass-through taxes from the operating revenue considered in the present matter. Staff pointed out that no reference to how Nicor does or does not make accounting entries for financial statement purposes can be found in Mr. Kahle's testimony.

Staff further argued that Mr. Adams strayed from reality in his attempt to tie the collection of pass-through taxes to the provision of service. It stated that when the Company incurs operating expenses, it does so in order to provide services to ratepayers. Staff contends that Nicor then collects operating revenue to recover operating expenses. Staff believes that this is not the case with pass-through taxes. Nicor itself has appropriately eliminated pass-through taxes from both operating revenue and operating expenses demonstrating the lack of connection between the provision of service and the collection of pass-through taxes. According to Staff, Mr. Adams also tried to tie pass-through taxes to purchased gas. In Staff's view, purchased gas, unlike pass-through taxes, is related to the service Nicor provides to ratepayers. Staff asserted that the cost of purchasing gas is financed by investors before the gas is later sold to ratepayers, thus creating a revenue lag. In Staff's opinion, purchased gas is not similar to pass-through taxes which are added on to ratepayer bills, provided to Nicor by ratepayers and then later remitted by it to taxing authorities.

Staff maintained that Mr. Adams went to great length to argue that pass-through taxes are collected in the same manner as operating revenue, but, in Staff's opinion, the form of the collection of pass-through taxes does not change their substance. Mr. Adams agrees that, although unlikely, pass-through taxes could be collected in some other manner. Staff asserted that were this unlikely event to occur, the Company's provision of service, operating revenues and operating expenses would not be affected, demonstrating that pass-through taxes are not part of the Company's operations. According to Staff, Nicor also referred to pass-through taxes as "Add-On Taxes". The belief is they are identical because, after the Company has calculated the ratepayers' bill for services, *i.e.,* the Company's operating revenue, the ratepayers' taxes that will pass-through Nicor to taxing authorities are added on to the ratepayers' bills. Adding pass-through taxes to a bill does not change them from pass-through taxes to revenue. Staff Initial Brief at 4-9.

According to Staff, Mr. Adams' confusion in considering pass-through taxes to be operating revenue is further demonstrated when he states that the Company "… is allowed to recover the expense of these taxes from customers through the ratemaking process, similar to any other expense." Staff found that because Nicor eliminated pass-through taxes from the ratemaking process, that this statement was inaccurate and misleading. Staff's position is that Nicor does not recover pass-through taxes as a cost of service when Nicor itself has eliminated them from the revenue requirement. *Id.*

Staff argued that Mr. Adams misrepresented the timing of the cash flows for pass-through taxes which makes it appear that the Company holds the cash for a much shorter time than it actually does. Staff stated that Mr. Adams' arguments are misleading and are not substantiated in the record when describing the timing of the collection and remittance of pass-through taxes. It was Staff's position that Mr. Adams' testimony demonstrated a process where Nicor bills the ratepayer for service and pass-through taxes in one month, but does not remit the funds for payment until the following month or at the end of a quarter. Staff cited Nicor's treatment of the Illinois Public Utility Tax and Municipal Utility Tax as examples. Nicor stated that the Illinois Public Utility Tax is received monthly but not remitted until after the end of a quarter. Municipal Utility Taxes, according to the Company, is received one month and then remitted the following month. Staff believed that while it is true that pass-through taxes are added on to a ratepayer's bill one month and collected later, this does not mean that it does not hold onto pass-through taxes for a period of time.

Staff maintained that Mr. Adams' testimony regarding Nicor's treatment of pass-through taxes falsely gives the Commission the impression that pass-through taxes are billed one month and received and remitted the next, thus appearing to be held by the Company for a very short period of time. The Company's explanation of its treatment of pass-through taxes, however, clearly delineates a process in which it receives pass-through taxes one month and remits them later. Staff contended that Nicor's explanation supported the conclusion that Nicor does indeed have possession of the pass-through taxes until after the end of the month or quarter in which the pass-through taxes are received. Mr. Adams calculated the length of time that the Company has pass-through taxes available for its use. His calculations were incorporated into Staff's CWC calculation. Staff Ex. 14.7

However, Staff argued that Mr. Adams inaccurately stated that no new evidence was presented to the Commission that had not been considered in prior dockets. Mr. Adams cited three dockets to support the Company's theory. (Peoples Gas Light and Coke Company and North Shore Gas ("Peoples Gas"); Ameren Illinois Utilities ("Ameren"); and Illinois-American Water Company ("IAWC")). Of the three dockets cited by Mr. Adams, Staff stated that information is presented here that was not presented or considered in those other cases. In Peoples Gas, Staff noted that the Final Order clearly stated that the Commission did not have the analysis to consider excluding pass-through taxes from the revenue portion of the CWC calculation. 2007 Peoples Gas Rate Case Order at 22. In Ameren, the Commission was not presented with the analysis necessary to show the difference between operating revenues and pass-through taxes. 2007 Ameren Utilities Rate Case Order at 62. In IAWC, a review of page 5 of each of the six appendices to the Final Order revealed that that pass-through taxes were not included in the CWC calculation; therefore, the Commission did not consider pass-through taxes in that proceeding. Illinois-American Water Company, Docket 07-0507, Order at 5. Staff argued that this docket is distinguishable, given the fact that 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 previously-mentioned dockets. Staff asserted that Mr. Kahle's testimony clearly demonstrated through the Company's responses to discovery requests that Nicor did indeed receive pass-through taxes from ratepayers, held those funds, and later remitted those funds to the taxing authorities. Staff Exs. 1.0 at 9-11; 14.0 at 6-9.

iii. Analysis and Conclusions

In our view, and after our analysis, we agree with Staff's position. We find it is proper to give the pass-through taxes zero revenue lag time in the CWC calculation. The fundamental idea lies in the theory that pass-through taxes are collected from the ratepayers and merely turned over by the Company to the taxing authority. Nicor seems to ignore the basic premise upon which CWC is based, as previously stated in the 2007 Peoples Gas Rate Case above. Since every dollar for pass-through taxes is collected from the ratepayers, the inflows and outflows earmarked for these taxes should be perfectly balanced. Thus the need for CWC should not arise with respect to pass-through tax transactions. Further, we note that the Company concluded the CWC requirement under the Net Lag and Gross Lag Methodologies produced identical results.

The schedule for payment for one of the pass-through taxes at issue, the Illinois Public Utility Tax is set forth in §35 ILCS 615/3:

> Each tax payer whose average monthly liability to the Department under this act was $10,000 or more during the preceding calendar year…shall make estimated payment to the Department on or before the 7th, 15th, 22nd and last day of the month during which tax liability to the Department is incurred…The amount of such quarter monthly payments shall be credited against the final tax liability of the taxpayer's return or that month.

Given the schedule set forth in the statute, the Commission finds that Mr. Adams' testimony setting the timetable for pass-through tax payments as month-in and month-out for the Illinois Public Utility Tax is misstated. We believe the frequency of the pass-through tax payment set forth in the statute is an example of how the actual pass-through tax transactions are in conflict with the Company's argument that the pass-through taxes collected from ratepayers should be included as revenue at a 50.81-day revenue lag as stated in its CWC analysis.

Nicor also sought to convince the Commission that its role as the intermediary in the pass-through tax transaction is a service to the ratepayers and directly related to its customers consumption of natural gas. The taxes in question are the Illinois Public Utility Tax, Illinois Gas Revenue Tax, and municipal gas receipt taxes. The Company attempts to treat the collection of the pass-through taxes as a cost of service upon which it is statutorily liable. Hence, it argued that it should be entitled to recover these expenses from the ratepayers in the form of revenue. We do not agree. The Company would have us believe there is an additional and measurable cost to pass-through taxes but fails to illustrate how a tax that is completely ratepayer-funded could generate any cost or expense. For example, while it is true that Nicor is statutorily liable for tendering taxes to the State, any "costs" which would arise by virtue of its role as the intermediary with respect to the Illinois Public Utility Tax are treated as follows:

> Any outstanding credit, approved by the Department, arising from the taxpayer's overpayment of its final tax liability for any month may be applied to reduce the amount of any subsequent quarter monthly payment or credited against the final tax liability of the taxpayer's return for any subsequent month. If any quarter monthly payment is not paid at the time or in the amount required by this Section, ***the taxpayer shall be liable for penalty and interest*** on the difference between the minimum amount due as a payment and the amount of such payment actually and timely paid.

35 ILCS 615/3. [emphasis added]. Given the fact that the costs incurred arise in the event that Nicor fails to pay the correct amount of revenue taxes or fails to pay on time, any penalties should be completely absorbed by the Company. The Commission finds that it is unreasonable for Nicor to pass this penalty on to the ratepayers in the form of an operating expense, nor should it expect to earmark the funds collected for pass-through taxes as revenue to pay for the Company's "cost" of acting as an intermediary for pass-through tax payments to the State.

Finally, Nicor argues that the Commission should consider our findings in the 2007 Peoples, Ameren, and IAWC rate cases as precedent for rejecting Staff's proposal. While the Company accurately recites the conclusions in these cases, these matters are distinguishable in that none of them include an analysis of the collection and remittance of pass-through taxes that was presented by Mr. Kahle in his testimony. Given this additional evidence, the Commission finds the inclusion of pass-through taxes at zero revenue lag days in the CWC analysis to be proper. Staff's adjustment to CWC is approved.

b. Balancing of Revenues and Expenses

i. Nicor's Position

The Company explained that it presented the determination of its CWC requirement under both the Net Lag and Gross Lag Methodologies, with both methodologies having produced identical results. Its calculation of its CWC requirement under the Gross Lag Methodology reflected a balance between the level of operating revenues and expenses.

Nicor noted that Staff used the Gross Lag Methodology to determine the Company's CWC requirement. Under the Gross Lag Methodology, operating revenues were analyzed separately from the operating expenses to determine the timing of the cash receipts and payments. However, Nicor stated that Staff's CWC analysis improperly reflected an imbalance in the level of revenues and expenses considered in the CWC analysis. It further asserted that Staff provided no explanation as to how or why the imbalance existed.

In support of its position on this issue, Nicor cited the order in the 2007 Ameren Rate Case, where the Commission rejected Staff's position that it was acceptable to have an imbalance between the level of revenues and expenses. 2007 Ameren Utilities Rate Case Order at 62.

The Company stated that the sole purpose of the CWC analysis is to analyze the timing of all cash receipts (*i.e.*, operating revenues) and cash outflows (*i.e.*, operating expenses). To arrive at an accurate determination of its CWC requirements, the level of revenues considered in the CWC analysis must be sufficient to reflect the payment of all cash operating expenses, and vice versa. If there is an imbalance between the level of operating revenues and operating expenses, Nicor asserted that there would be an artificial and improper imbalance in the resulting level of CWC requirement. As such, the Company argued that the imbalance between the level of operating revenues and operating expenses reflected in Staff's CWC analysis has effectively understated its CWC requirement and, therefore, Nicor's rate base, by more than $20.7 million.

Nicor averred that if the level of revenues and expenses are not in balance, the CWC analysis cannot accurately reflect the timing differences addressed within the analysis. In this regard, Nicor alleged that Staff's analysis is flawed, as it reflects expense dollars paid, for which, there are no corresponding revenues to absorb the expenses. Further, Staff has not indicated the source of funds outside of the CWC analysis, from which, the additional cash expenses might be funded. From these flaws, Nicor stated that one conclusion is self-evident—Staff's CWC analysis does not include sufficient revenues to pay all cash operating expenses. Therefore, according to Nicor, Staff's CWC requirement is understated and does not reflect the actual timing of all revenues received.

ii. Staff's Position

Staff challenged Nicor's introduction of the balancing of revenue and expenses, as reflected in the CWC analysis, as a novelty. Staff noted that Nicor has held to this theory even though Mr. Adams admitted that he has no authoritative pronouncement to support that position. Nicor Ex. 42.0 at 10. In fact, Staff argued, 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 at 11-12. In the current docket, Staff noted, cash payments exceed receipts in its CWC calculation by only 0.01% ($2,810,695 - $2,810,315, divided by $2,810,695). Staff Initial Brief, Appendix A at 10.

Staff maintained that Nicor is incorrect in stating that Staff failed to include sufficient cash receipts for payment of all expenses. Staff's analysis reflected payments, for which, there are no corresponding cash receipts. Staff's analysis did include sufficient cash receipts for payment of all expenses since cash payments exceeded receipts by only one-hundredth of one percent. Staff's analysis merely used two different measures of lag days for two different types of cash receipts. Staff argued that this treatment for different types of cash receipts is the same as using different measures of lead days for different types of expenses. To illustrate its point, Staff noted that 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. *Id.*

Staff also noted the AG's support for Staff's proposed adjustment to CWC, citing AG Initial Brief at 9.

iii. Analysis and Conclusions

The Company focuses its argument in favor of balancing revenue and expenses on its analysis of CWC using the Net Lag and Gross Lag Methodologies. Nicor argues that its calculations using the Gross Lag Methodology show a balance between the level of operating revenues versus operating expenses. Yet, it objects to Staff's analysis using the same methodology. Nicor states that Staff's CWC analysis improperly reflects an imbalance between revenue and expenses and argues that Staff did not include sufficient cash receipts for payments of all operating expenses. It contends that Staff's analysis using the Gross Lag Methodology has effectively understated its CWC requirement by $20.7 million. Staff counter-argues that its analysis included sufficient cash receipts and noted the resulting imbalance between revenue and expenses in the CWC calculation was measured at 0.01%. Staff notes the CWC determinations made by the Commission in two of the most recent three rate cases have been based on analysis which were not equal.

While both parties have chosen to rely on past Commission findings to support their positions, we must focus on the facts presented here. The Company argued that Staff's analysis is flawed, but has failed to provide the Commission with any analysis to counter Staff's CWC determination. Further, we find that the imbalance between operating revenue and expenses using Staff's calculations is slight and its overall impact is inconsequential to the CWC requirement. As such, Staff's analysis of the balancing of the Company's operating revenues and expenses is approved.

2. Gas In Storage

Nicor calculated that its working gas in storage for the test year will be $95,645,000. Nicor Ex. 11.0 at 15. The Gas in Storage balance represents a 13-month average (December 2008 through December 2009) of month-end balances of working gas stored in Nicor's owned and leased facilities, net an adjustment for accounts payable. Nicor Ex. 4.1 at 10, Nicor Initial Brief at 17. The AG/CUB seek to reduce the amount of gas in storage by 31%, or, $29,228,000.

a. The AG/CUB Position

AG/CUB witness Mr. Effron was of the opinion that Nicor overestimated the amount of working gas that will be in storage for the test year. He recommended reducing Nicor's proposed working gas in storage component. Mr. Effron calculated an average balance of gas in storage of $66,359,000, ($95,645,000-$29,228,000) which includes adjusting the gas in storage balance for related accounts payable. AG/CUB Ex. 4.1, Sched. B-3. Mr. Effron's proposal would reduce Nicor's proposed annual revenue requirement by approximately $4,599,000.

He testified that the forecasted balances used by Nicor for the test year are significantly higher than the actual recent balances of gas in storage. This is especially true for the months of July through December, which account for nearly all of the differences between the actual average balance in 2007 and the forecasted average balance in 2009. AG/CUB Ex. 1.0 at 10. He stated that the reason for this pronounced difference during these months is that storage volumes are lower in the first six months of the year, and, pursuant to Nicor's last-in-first-out ("LIFO") method of accounting for gas in storage, the average price of gas in storage is also lower. *Id.* at 11-12.

Mr. Effron also stated that the weather has an impact on storage activity in the early months of the year, when Nicor's inventory is being drawn down. AG/CUB Ex. 4.0 at 6. Since there is a lag between the time when gas is injected into storage and when it is withdrawn, AG/CUB propose that this Commission order Nicor to revise its requested working capital gas in storage amount to account for this change. CUB Initial Brief at 4.

b. Nicor's Position

Nicor witness Mr. Bartlett disagreed with Mr. Effron's proposed alternative storage field month-end volumetric balances. According to Mr. Bartlett, Mr. Effron did not explain why his use of actual storage balances from the last six months of 2007 and the first six months of 2008 are more representative than other years. Nicor Ex. 19.0 at 4. Mr. Bartlett stated that Mr. Effron proposed to replace Nicor's forecasts with the actual month-end volumetric balances from December of 2007 through September of 2008, and the volumetric balances from October and November of 2008. The October and November 2008 volumetric balances that Mr. Effron used, according to Mr. Bartlett, are not based on actual prior period month-end balances, but, instead, are derived from a combination of storage data from September of 2008 and from October and November of 2007. He further stated that use of actual balances for one year can be misleading. Use of a three or four year average is a superior way of ensuring that year-to-year weather variances are not taken into consideration. Nicor Ex. 38.0 at 3-4, 8.

Mr. Bartlett also testified that when actual volumes are used for this calculation based on a three or four year average, the result is similar to what Nicor proffered here. Using the most recent three years ending with December of 2007 and applying the test year gas prices results in a 13-month average gas in storage component of $90,448,115 for the test year. Using actual volumes for the most recent four years ending with December of 2007 results in a 13-month average gas in storage component of base rates of $97,916,836 for the test year. *Id*., Nicor Ex. 38.1.

Mr. Bartlett posited that the weather and Transportation customers' use of their storage with Nicor have an impact upon Nicor's month-end storage inventory balances. Nicor Ex. 19.0 at 4-5. He testified that it is not realistic, as Mr. Effron suggested, to dismiss the impact that the weather has on storage during the months of May through December. While it is true that Nicor experiences weather-related demand during the months of January through April, an increase in demand for natural gas can begin as early as September, and this increase in demand grows every month through December. Also, the heat in the summer months has an impact on storage activity, as it causes spikes in demand for natural gas by electric generation customers. Additionally, Mr. Bartlett stated that Nicor's Transportation customers often have net withdrawals of gas from on-system storage during the month of August. Nicor Ex. 38.0 at 6-7.

c. Analysis and Conclusions

The issue here is whether the use of estimated (forecasted) balances, as opposed to actual balances, is more accurate. While generally actual balances would seem to be more accurate, Mr. Effron only used one year of information, and he used information that does not appear to be totally accurate for the months of October and November of 2008. Even assuming that Mr. Effron's figures for October and November of 2008 are correct, he has only taken one year into account. As Mr. Bartlett pointed out, anomalous weather and other out of the ordinary conditions can occur in any given year. Therefore, Mr. Bartlett's calculation, which is based upon estimated forecasted balances, is more accurate than that proposed by Mr. Effron. We also note that the veracity of Mr. Bartlett's forecasted averages is further bolstered by his calculations based upon actual figures, which are remarkably similar to his forecasted averages. There is no indication of record that Mr. Bartlett's three-year and four-year averages, which are very close to the amount Nicor seeks, but are computed using actual volumes, are incorrect. Therefore, we conclude that Mr. Bartlett is correct. No adjustment to the amount Nicor seeks for gas in storage is warranted.

3. The Pension Asset

The Company is seeking to include in rate base $142,044,000 related to net pension assets. Staff and AG/CUB each propose removal of the pension asset from rate base.

a. Nicor's Position

Nicor's witness Mr. Gorenz argued that the $142,044,000 reflects investments made by the Company in a pension trust in compliance with its obligations under its defined benefit pension plan. Although the Commission did not include this asset in the Company's 2004 Rate Case, Nicor maintained that there currently are issues on appeal from ComEd's 2005 rate case, *Commonwealth Edison Co.*, Docket 05-0597, that may impact whether this asset should be included in rate base. In order to preserve its rights, the Company proposes inclusion of this asset in the test year rate base. Nicor Initial Brief at 20.

b. Staff's Position

Staff witness Ms. Hathhorn testified that Staff opposes the Company's inclusion of its pension asset in rate base since it was paid for with ratepayer funds. Ms. Hathhorn stated that the Commission has twice ruled with Staff on this issue and no facts have changed to merit a reversal. Staff Ex. 2.0 at 3-10, Sched. 2.01, Ex. 15.0 at 3-8, Sched. 15.01; Nicor Ex. 26.2. Staff argues that the pension asset that the Company seeks to include in rate base is a cumulative balance from when the pension plan initially began and that the Company provides no new evidence that the funds contributed in the past were not provided by ratepayers. Staff Initial Brief at 11-12.

Staff also argues that the Company's position that a court decision in the pending ComEd appeal will most likely resolve the pension asset issue is unconvincing since the facts of the two companies are so dissimilar. Staff Initial Brief at 10.

Staff recommends a $142,044,000 adjustment as a rate base deduction.

c. The AG/CUB Position

The AG argued that Nicor proposes to include a pension asset consisting of an offset to its accrued liability for postretirement benefits other than pensions, plus smaller retirement accruals, against prepaid pensions into rate base under the category "Retirement Benefits, Net". The AG maintained that Nicor ignores the Commission's express directive that net pension asset must be eliminated from rate base. Mr. Effron testified that, according to prior Commission orders in Nicor's last two rate cases, Dockets 95-0219 and 04-0779, the net pension asset should be eliminated from rate base. Mr. Effron proposed that this prepayment, along with the related balance of accumulated deferred income taxes, should be deducted from plant in the calculation of rate base. The net effect of this adjustment is a reduction of the test year rate base by $142,044,000. AG/CUB Ex. 4.1, Schedule B; AG Initial Brief at 10-11.

CUB asserted that there is no basis either in fact or law for the Commission to alter the rulings in the Company's last two rate case orders. CUB Initial Brief at 4. CUB maintained that in both of these orders, the Commission determined that the pension asset should be excluded from base rates because it was created from ratepayer supplied funds. Docket 04-0779, Order at 22, quoting Docket 95-0219, Order at 9. CUB recommended that the Commission eliminate the Company's requested pension asset from its approved rate base and reduce the Company's test year rate base in the amount of $142,044,000. AG/CUB Ex. 1.0 at 15.

d. Analysis and Conclusions

In both of Nicor's last two delivery service rate cases, Dockets 95-0219 and 04-0779, it requested to include the balance of "Retirement Benefits, Net" in rate base which the Commission rejected. In Nicor's previous Rate Case, Docket 95-0219, the Commission found that "[Th]e proposal to eliminate the net Pension Asset from rate base is consistent with past Commission orders which found that the over-funded pension asset was created from ratepayer supplied funds." Docket 95-0219, Order at 9. The Commission held that ratepayers should not be denied the benefits associated with the previous overpayment for pension expense which they funded. In Docket 04-0779, the Commission again eliminated the Company's prepaid pension asset from rate base. *Id.* at 21.

The Commission finds that the facts have not changed since the time these two Orders issued and adopts the Staff and AG/CUB's proposal to remove $142,044,000 from rate base.

4. Gross Plant-The Accuracy Of Nicor's Estimated Plant Additions For 2008 And 2009

Nicor seeks to include approximately $750 million in gross plant in rate base. Staff proposed to reduce Nicor's gross plant by 2.87%, or, $8.8 million, as well as the related impacts upon accumulated depreciation, accumulated deferred income taxes and depreciation expense, based on Mr. Ostrander's four-year analysis. *See, e.g.,* Staff Initial Brief at 17, Staff Appendix A thereto, at 19-24.

a. Nicor's Position

Nicor witness Mr. D'Alessandro testified that, in the past, Nicor's forecasts for plant additions have been remarkably accurate and they should be used here. According to Mr. D'Alessandro, the accuracy of Nicor's actual plant addition expenditures has been, on average, within 3% of its forecasts for the years 2004 through 2007. Nicor Ex. 18.0 at 9-10.

Mr. D'Alessandro further averred that Staff witness Mr. Ostrander's proposed disallowance is incorrect. Mr. Ostrander did not use the same type of evidence for each year of his 2004 to 2007 analysis. While Mr. Ostrander compared Nicor's original capital expenditure budget to Nicor's actual expenditures for the years 2005 through 2007, he did not use the same evidence for 2004. According to Mr. D'Alessandro, for 2004, Mr. Ostrander used a mid-year capital expenditure forecast, instead of Nicor's original 2004 capital expenditure budget.

He asserted that Mr. Ostrander's use of the mid-year capital expenditure forecast has a "dramatic impact" on the results of his analysis. He opined that, if Mr. Ostrander had used Nicor's original capital expenditure budget, which he did do for the years 2005 through 2007, and compared that figure to the amount of Nicor's actual capital expenditures for that year, he would have discovered that Nicor actually underestimated its 2004 original budget by $10 million, or, 6%. He concluded that, when the correct 2004 evidence is applied to Mr. Ostrander's four-year analysis, the actual variance over the four-year period is less than 1%, or, 0.52%, not the 2.87% asserted by Mr. Ostrander. Nicor Exs. 37.8, 37.0 at 12-13.

Additionally, Mr. D'Alessandro stated that, if a five-year average were used for this analysis, it would establish that Nicor has been over-budget. Finally, he claimed that Mr. Ostrander's proposed adjustment for 2008 and 2009 conflicts with Nicor's actual 2008 year-to-date experience. Through October of 2008, Nicor has actually been $6,635,100 over-budget. Based on this testimony, Nicor concluded that it makes no sense to apply a 2.87% reduction in 2008 plant additions when the evidence demonstrates that it is over-budget. Staff Cross Ex. 3; Nicor Initial Brief at 22.

b. Staff's Position

Staff witness Mr. Ostrander testified that Nicor's 2008 and 2009 estimated plant additions should be reduced by 2.87% for each year. His adjustment is based on a comparison between Nicor's annual forecast for plant additions to its actual expenditures for the past four years, which are 2004-2007. Staff Ex. 4.0 at 3-4. He further testified that, when one compares actual plant additions to budgeted plant additions for the years 2004 through 2007, it becomes clear that during that four-year period, Nicor's actual plant additions have been under-budget by as much as 4.26% and as little as 0.67%. Staff Ex. 4.0 at 4; Sched. 4.01 at 2.

Mr. Ostrander noted that in Nicor's last rate case, Docket 04-0779, the Commission reduced Nicor's forecasted plant additions, based on an average of Nicor's historic under-budget variances, even when the adjustment was only 0.8%. In fact, Nicor has acknowledged that its plant additions have been, on average, within 3% of its forecast for the years 2004 through 2007. Staff Exs. 4.0 at 4, 17.0 at 4.

Staff also asserted that the budget amount Mr. Ostrander relied upon for his 2004 calculations (the figure that Mr. D'Alessandro called into question) is what Nicor provided in response to a data request in Nicor's last rate case. Staff requested the identical information in this docket as well. Both Staff and the Commission relied upon the budget amount provided by Nicor to make a plant adjustment in Nicor's last rate case. Staff concluded that therefore, it would be not be appropriate to use another figure when making this calculation. Staff Initial Brief at 15.

Further, Staff contested Mr. D'Alessandro's averment that a five-year period, instead of a four-year period, should be used to calculate an average of actual plant additions to budget variance. Staff maintained that its choice of a four-year period is the same four-year period that was used in the procedure that Nicor performed to recommend an original cost determination. Staff Ex. 4.0R at 7, Staff Initial Brief at 15-16.

Also, according to Staff, Nicor's five-year historical analysis is flawed, as it contains an incorrect 2003 budget. In response to data requests, Nicor indicated that the 2003 budget for plant additions was $160,042,000, not the figure of $157,402,000 that Mr. D'Alessandro used. Staff Initial Brief at 16.

c. AG/CUB Position

Mr. Effron initially recommended further reducing Nicor's forecast of plant additions for 2008 and 2009. In his rebuttal testimony, Mr. Effron accepted Nicor's contention that it would be a "double-count" to adjust both plant additions and the cost of removal based on plant-related expenses through June or September of 2008. While Mr. Effron adjusted his calculation of test year plant in service based on Nicor's rate of capital spending in 2008, (*see,* Section IV(c)(4) herein, entitled "Accumulated Reserve for Depreciation and Amortization," below) he continued to recommend that the test year average balance of accumulated depreciation should be adjusted, in light of the net cost of removal projected for 2008 and 2008. AG/CUB Ex. 4.0 at 2; CUB Initial Brief at 6.

d. Analysis and Conclusions

We agree with Staff's contention that Nicor's 2008 and 2009 estimated plant additions should be reduced by 2.87%. In fact, even Nicor's witness Mr. D'Alessandro testified that Nicor's actual plant addition expenditures have been, on average, within 3% of its forecasts for the years 2004-2007. 3% is remarkably close to Mr. Ostrander's figure of 2.87% for plant reductions.

Also, we agree with Staff's contention that any incorrect dollar amount used by Mr. Ostrander in his calculations should not be changed. The amount used by Staff in its four-year calculation was relied upon by Staff and the Commission in Nicor's last rate case in determining reductions to plant additions. That amount was also tendered by Nicor to Commission Staff in discovery in that case. If it is incorrect, it is incorrect due to Nicor's failure to supply this Commission with accurate information.

The gist of Mr. Ostrander's testimony is that historically, Nicor's plant additions have been under-budget. There is no reason why ratepayers should have to pay for a budget that is greater than what a utility actually pays for with the funds that are budgeted. Nicor additionally argues that Staff's average should include a five-year period from 2003 to 2007. It proffers no reason, however, to indicate why five years should be used instead of four years. We also note that it appears that Nicor originally produced a four-year calculation.

Further, we disagree with Nicor's assertion that inclusion of 2008 figures establishes that Nicor has been over-budget. Even if there were one year (2008) in which Nicor's actual plant additions expenditures are over-budget, this does not establish that Nicor will be over-budget until its next rate case. Even assuming that the information provided by Mr. D'Alessandro regarding January through October of 2008 actually establishes that Nicor was over-budget for 2008, this does not change the fact that Nicor was under-budget for plant additions for the previous four years. Any information regarding 2008, without more, merely establishes that anomalous situations can occur, thus, reinforcing the need for figures regarding more than one year.

5. Accumulated Reserve For Depreciation and Amortization

Nicor determined that the test year amount of its depreciation reserve is $2,694,352,000. AG/CUB proposed a $4,940,000 adjustment to the average test year depreciation reserve, which represents a reduction in Nicor's budgeted net removal costs. Nicor Initial Brief at 22.

a. Nicor's Position

Nicor's witness Mr. Gorenz presented Nicor's calculation of its depreciation reserve, which, he asserted, was determined by taking the actual balances as of December 31, 2007, and adjusting for both 2008 and 2009 depreciation and amortization, retirements, removal cost and salvage, and transfers. Nicor Exs.11.0 at 14-15, 11.1, Sched. B-6. Removal costs are charged to depreciation reserve and therefore, removal costs increase rate base. Nicor Ex 26.0 at 16.

According to Mr. Gorenz, Mr. Effron's proposed adjustments to net removal costs for 2008 and 2009 are not accurate. Mr. Effron's calculations regarding 2008 were estimated based on actual removal costs for the months of January through September of 2008. Mr. Gorenz testified that annualizing these costs, based on what occurred in the first nine months of 2008, is overly-simplistic. Nicor does not incur the same removal cost each month. In fact, historically, Nicor spends, on average, 30% or more of its removal costs in the last quarter of the year. Using a 30% fourth quarter expenditure rate reduces Mr. Effron's proposed adjustment by $1,011,000. Mr. Gorenz additionally averred that Mr. Effron inappropriately included $1,358,000 in his 2008 figure. This number represents the costs associated with the transfer of certain plant to non-utility property in 2008. Nicor Ex. 45.0 at 15-16.

Mr. Gorenz also testified that budgeted 2009 removal costs, which are a component of Nicor's capital expenditures budget, were developed through rigorous budgeting that involve input from subject-matter experts throughout Nicor, taking into account the specific capital requirements of the business. *Id.* at 16. Further, Nicor budgeted increases in removal expenditures for 2008 and 2009 because it plans to annually replace 40 miles of cast iron main and 9,000 copper services. Nicor Ex. 2.0 at 18.

b. AG/CUB Position

AG/CUB witness Mr. Effron testified that Nicor's expenditures related to one of the components of Nicor's depreciation reserve - its calculation of its net removal costs and retiring plant, net of any salvage value received, are charged against the depreciation reserve. He averred that Nicor's forecasts of its removal costs do not represent the actual costs that Nicor incurred for removal in previous years. He concluded that therefore, Nicor's depreciation reserve should be modified. AG/CUB Ex. 1.0 at 8-9.

Mr. Effron stated that he analyzed Nicor's actual removal costs for the years 2005, 2006 and 2007. He concluded that Nicor's forecasts are substantially in excess of the cost of removal in previous years. The forecasted costs of removal are

$17,544,000 for 2008 and $17,267,000 for 2009. However, Mr. Effron asserted, the actual cost of removal in 2005 was $6,854,000; in 2006, it was $6,347,000; and, in 2007, it was $6,914,000. He recommended that the forecasted cost of removal in 2008 and 2009 should be adjusted to reflect the average cost of removal for 2006 and 2007. AG Initial Brief at 13.

Mr. Effron also analyzed the actual cost of removal that Nicor incurred for January through September of 2008. That cost is greater than it was in the previous years that Mr. Effron analyzed, it was $10,619,000. Based on the first nine months of actual removal costs incurred in 2008, Mr. Effron estimated that Nicor's actual costs of removal for 2008 will be $14,159,000, which is $3,385,000 less than Nicor's projected removal costs for 2008, and $3,108,000 less than Nicor's projected removal costs for 2009. When his estimates are added to Staff's adjustment to accumulated depreciation reserve, the total net adjustment that AG/CUB seeks for both years is $4,940,000. CUB Initial Brief at 7.

c. Staff's Position

Staff witness Mr. Ostrander agreed with Nicor that Mr. Effron's adjustment to Nicor's accumulated depreciation reserve would overstate the impact on Nicor's test year rate base. Staff Ex. 17.0 at 6-7. He noted that the increase in removal costs is due to Nicor's accelerated rate of replacement of cast iron mains and copper service replacements pursuant to its Rider 30-Qualifying Infrastructure Plant. Mr. Ostrander expressed no opinion regarding whether Rider 30 should be approved. He commented that Nicor has identified approximately $12.3 million of incremental plant additions in the 2009 test year which are associated with the accelerated main replacement program, which also should be removed from Nicor's rate base due to any Commission disapproval of Nicor's claim for its accelerated main replacement program for the test year. Thus, if the Commission does not approve Nicor's accelerated main replacement program for both Rider 30 and the test year, Mr. Effron's adjustment for the increased cost of removing retired plant is appropriate. *Id.*

d. Analysis and Conclusions

At issue is whether Nicor's increased removal costs, which are due to implementation of Rider 30-Qualified Infrastructure Plant, should be included in Nicor's Depreciation Reserve. For the reasons stated in Section XII(F) herein, which addresses Rider 30-Qualified Infrastructure Plant, we conclude that it is not appropriate to include the additional Depreciation Reserve that would result from implementation of Rider 30-Qualified Infrastructure Plant. We conclude, therefore, that the AG/CUB adjustment is approved.

6. Incentive Compensation

See, Section V(B)(1) and V(C)(1), below.

7. Other-Accumulated Deferred Income Taxes ("ADIT")

In keeping with its recommendation that the Commission eliminate the "Retirement Benefits, Net" pension asset from its rate base, the AG/CUB asserted that this Commission should reduce Nicor's balance of accumulated deferred income taxes for the prepaid pension asset by $89,581. Consistent with this adjustment to the accumulated reserve for depreciation and amortization, Staff recommended that this Commission increase the balance of accumulated deferred income taxes by $1,130,000. No party has contested the propriety of the AG/CUB assertion. It is therefore approved.

OVERALL CONCLUSION ON RATE BASE

Based on the gas utility rate base as originally proposed by Nicor along with the conclusions herein, the gas utility rate base for Nicor approved for purposes of this proceeding is $1,336,495,000. The rate base may be summarized as follows:

Nicor Gas Rate Base (in thousands)

Description		Amount
Gross Utility Plant	$	4,466,572
Accumulated Provision for Depreciation and Amortization		(2,698,958)
Net Plant	$	1,767,614
Additions to Rate Base		
Cash Working Capital		62,602
Materials and Supplies		5,634
Gas in Storage		95,645
Retirement Benefits, Net		(137,082)
Deductions From Rate Base		
Construction Work in Progress Subject to AFUDC		(9,232)
Accumulated Deferred Income Taxes		(181,767)
Customer Deposits		(38,644)
Budget Payment Plan Balances		(160,582)
Regulatory Tax Liability		(45,237)
Investment Tax Credits		(11,334)
Reserve for Injuries and Damages		(883)
Customer Advances for Construction		(10,239)
Rate Base	$	1,336,495

The development of the approved gas utility rate base adopted for Nicor for purposes of this proceeding is shown in Appendix A to this Order.

V. OPERATING EXPENSES

A. OVERVIEW

Nicor's revised proposed base rate Operating Expenses, after adjustments and including income taxes, are $567,475,000. The components of Nicor's revised proposed base rate operating expenses are; (1) $311,249,000 in other operating and maintenance ("OO&M") expense; (2) $1,371,000 as the cost of gas that is not recovered through Rider 6; (3) $178,254,000 in depreciation expense; (4) $20,250,000, in taxes other than income taxes; and (5) $56,351,000 of income taxes. Nicor Initial Brief at 24, Attachment 1.

Nicor's revised Operating Expenses are based upon changes to its initial proposal. These revisions were the result of Nicor, Staff and Intervenors coming to agreement on several issues. Nicor revised its adjustments in response to fifteen Staff-proposed, and three Intervenor-proposed adjustments. The total amount of adjustments made in response to Staff's proposals is approximately $4,559,000. The adjustments it made in response to intervenors' proposals are approximately $2,695,000. Nicor Initial Brief at 24.

B. UNCONTESTED ISSUES

Initially, Nicor accepted several proposed adjustments. They are as follows:

a. Incentive Compensation Adjustment: Nicor accepted the recommended disallowance of certain incentive compensation included within consolidated pool charges, including Stock Appreciation Rights ($117,000) and Restricted Stock, Performance Units and Annual Bonus ($2,276,000).

b. Unamortized Rate Case Expense: Nicor accepted a $112,000 reduction in unamortized rate case expense. This adjustment accounts for an additional three months of amortization that will have been recovered through existing rates by the time the new rates take effect.

c. Property Tax Expense: Staff recommended a $503,000 reduction in forecasted property tax expense and $89,000 in plant, which Nicor accepted.

d. Income Tax/Lobbying Expenses: A proposed correction of $155,000 in the calculation of income taxes on non-deductible lobbying expenses was agreed to.

e. In addition, at trial, Nicor agreed to a rate base reduction relating to the NRRC, which resulted in a corresponding decrease to operating expenses.

These adjustments are reasonable and they are hereby approved. Additional proposed adjustments that were resolved later on in this proceeding are the following:

1. Incentive Compensation

Staff witness Ms. Hathhorn proposed to reduce Nicor's budgeted test year expenditures to allow for recovery of incentive compensation related to a Nicor program called "The At-Fault Hit Ratio per 1,000 Locates" at a 50% payout level. This program is a component of Nicor's Manager Incentive Plan. Staff's adjustment is a reduction in the amount of $55,000. Nicor accepted Staff's proposed adjustment on this issue. As a result, the amount Nicor now seeks to recover under its Manager Incentive Plan is now $899,329, which is a $55,000 reduction from $954,329. Nicor Initial Brief at 26. This reduced amount is reasonable and it is hereby approved.

2. Pension Asset – Credit

Nicor originally sought to recover $16,743,000 as its pension credit. However, Nicor adjusted its pension credit to reflect current pension trust assets and values through June 30, 2008. Nicor witness Mr. Gorenz proposed that the test-year pension credit, as adjusted, is $7,972,000. Nicor Ex. 26.0 at 32-36. Neither Staff nor any other party objected to this proposal. This adjustment is reasonable and it is hereby approved.

3. Environmental Expenditures

Nicor's proposed environmental expense is $564,400 for the disposal of polychlorinated biphenyls ($282,200 is charged to OO&M expense and $282,200 is charged for removal/retirement expense). This amount was agreed-upon between Staff and Nicor. *See,* Staff Ex. 3.0 at 20-21. These amounts are reasonable and they are hereby approved.

4. Invested Capital Taxes

Staff witness Ms. Hathhorn recommended that the state-invested capital tax rate should be 0.80%, but this should not be reflected in the calculation of the Gross Revenue Conversion Factor. Instead, Staff averred that the incremental increase in such taxes should be reflected as an adjustment to operating expenses, to be updated, based upon the final Commission-approved rate of return and rate base. Nicor agreed to accept this proposal. This approach is reasonable and it is hereby approved.

5. Promotional Expenses

Nicor accepted Staff and the AG/CUB's proposal to remove $264,000 from the proposed revenue requirement which reflects costs associated with promoting and maintaining the Company brand. *See,* Staff Ex. 3.0 at 12-16; AG/CUB Ex. 1.0 at 27-28. This adjustment is reasonable and it is hereby approved.

6. Training/Seminar Expenses/Economic

Nicor accepted Staff's proposal to disallow training/seminar expenses, which are in the amount of $404,000. Staff Ex. 3.0 at 16-18; Nicor Ex. 26.0 at 30. Nicor also accepted a $92,000 reduction to the amount it forecasted for economic development contributions. Nicor Initial Brief at 28. These adjustments are reasonable and they are hereby approved.

7. Membership Dues

Nicor accepted Staff's proposal to remove membership dues for community and economic development organization, in the amount of $128,000, from its proposed revenue requirement. Staff Ex. 3.0 at 18-20; Nicor Ex. 26.0 at 29-31; Nicor Initial Brief at 28. This adjustment is reasonable and it is hereby approved.

8. Certain Charitable Contributions

Staff recommended adjustments to Nicor's forecasted charitable contributions for the following: a $25,000 contribution made to Chicago United; a $6,000 contribution to the "Conference Board;" and a $53,000 adjustment to contributions that are less than $5,000. Nicor accepted these adjustments. Staff Ex. 2.0 at 9-12. These adjustments are reasonable and they are hereby approved.

9. Taxes Other Than Income Taxes

Staff and the AG/CUB proposed three tax-related adjustments. The first is derivative from Staff's incentive compensation adjustment, the second regards invested capital taxes, and the third concerns property tax expense. Based on those proposals, Mr. Gorenz revised Nicor's requested amount to $20,251,000. Nicor Ex. 26.0 at 47. These issues are, therefore, no longer contested. These adjustments are reasonable and they are hereby approved.

C. CONTESTED ISSUES

1. Incentive Compensation Costs And Expenses

The Company maintains that there are $325,100 in costs attributable to its Incentive Compensation Units ("ICU") Plan. Staff and AG/CUB recommend this amount should be deducted from operating expense.

a. Nicor's Position

Nicor's witness Bacidore argued that Nicor's $325,100 costs attributable to its ICU Plan are prudent and reasonable and therefore should be recovered. Ms. Bacidore stated that the plan was in effect from 1968 to 1980 and the costs related to the ICU Plan were last included in the Company's revenue requirement in its 2004 Rate Case. Nicor Initial Brief at 29-30. Ms. Bacidore maintained that Staff's proposed disallowance should be rejected because: (1) the Commission has repeatedly allowed the Company to recover these expenses; (2) Nicor has an ongoing obligation to pay these expenses, similar to its obligation to pay pension or retirement benefits; and (3) contrary to Staff witness Hathhorn's assertions, payout under the ICU Plan is not completely tied to financial goals. Nicor Ex. 41.0 at 2-3; Nicor Initial Brief at 29-30.

The Company argued that although the ICU Plan is not available to its current employees, it must continue to meet its obligations related to the plan requirements.

Nicor asserted that these obligations are identical to its obligation to provide post-retirement medical and pension benefits to its retirees. Nicor also argued that an employee's eligibility for the ICU Plan was not based upon its financial goals.

The Company maintained that Staff's citation to various Commission Orders is misplaced. According to Nicor, Staff overlooks a number of critical distinctions between the ICU Plan and the incentive compensation plans previously addressed by the Commission. In each of the Commission Orders upon which Staff relies, the incentive compensation plans under consideration were active. In contrast, the Company's ICU Plan is inactive, and it has been inactive since 1980. Nicor stated that on at least three occasions since the plan became inactive, the Commission has included the costs of the ICU Plan in rates.

Nicor maintained that none of Staff's cited Orders involves expenses resulting from a discontinued incentive compensation plan. It is this distinction, according to the Company, that is important because while the Commission repeatedly has addressed the standards for cost recovery for ongoing incentive compensation plans, it never has applied the same standards to plans that are no longer in effect. The Company acknowledges that the Commission did not explicitly discuss the ICU Plan expenses in the 2004 Rate Case, but also notes that neither Staff nor any party opposed the ICU Plan costs requested in that proceeding.

Finally, the Company contended that Staff's claim that the payment of benefits is based entirely on company performance completely overlooks the fact that the event that qualifies an employee for the ICU Plan is not related to financial goals. Nicor maintained that share points are the means of qualifying for a reward under the ICU Plan and the value of the point shares fluctuates according to stock value and Company performance.

b. Staff's Position

Staff witness Hathhorn proposed to disallow ICU-related expenses because this cost is based on the achievement of financial goals, of which the Company has demonstrated no benefits to ratepayers. Staff cited several Commission cases in support of its contention that Nicor failed to meet its burden of demonstrating that its incentive compensation plan has reduced expenses and created greater efficiencies in operations which provide net benefits to ratepayers. Ms. Hathhorn maintained that the Company cannot demonstrate these benefits because there are no active employees of the ICU Plan. Staff Ex. 2.0 at 11-14, Ex. 15.0 at 10-11; Staff Initial Brief at 22-26. Staff recommends a $325,000 operating expense deduction.

c. The AG/CUB Position

AG/CUB argued that Nicor failed to meet its burden of proving that the cost of its incentive compensation program is just and reasonable. AG/CUB contended that Nicor did not show both that the entirety of its incentive compensation program confers specific savings or other tangible benefits on ratepayers and that the ICU Plan reduces expenses and creates greater efficiencies in operations. CUB Initial Brief at 7-8.

AG/CUB concluded that the Commission should adopt the recommended adjustment of Ms. Hathhorn and Mr. Effron and eliminate operating expenses for ICU plan costs related to shareholder-oriented goals. Staff Ex. 15.0 at 10; AG Initial Brief at 14.

d. Analysis and Conclusions

Although the ICU Plan was created and administered in accordance with Commission policies, the Commission finds that the evidence does not demonstrate that the costs related to the Company's ICU Plan are just and reasonable. The plan is no longer in effect and payout under the Plan is tied to financial goals. Recent Commission orders have set forth the requirements that incentive compensation plans demonstrate tangible benefits to ratepayers, and that incentive compensation not be based on shareholder goals. In Docket 04-0779, the Commission held:

> Costs related to incentive compensation are recoverable in rates only if the utility demonstrates tangible benefits to ratepayers. *See,* e.g., 03-0403 at 15 ("[T]o recover incentive compensation, the plan must confer upon ratepayers specific dollar savings or other tangible benefits. Furthermore, the degree of benefit that accrues directly to ratepayers, rather than to other stakeholders, is a significant factor in determining whether incentive compensation should be recovered in rates.)

Nicor Rate Case Order at 44. The Commission fails to see the tangible benefit to ratepayers from this program and holds that the Company's ICU Plan costs are not just and reasonable. We therefore conclude that Staff's adjustment is in order.

2. Uncollectible Accounts Expense

Nicor proposed a test year Uncollectible Accounts Expense in the amount of $68,311,000. Nicor Initial Brief at 31. Staff proposed a disallowance reducing this expense by $6,981,000. AG/CUB proposed to reduce this expense by $13,265,000. AG Initial Brief at 16.

a. Nicor's Position

Nicor witness Mr. Gorenz testified that Nicor's uncollectible expense for the 2009 test year is forecasted to be $68,311,000, or 2.25% of total test year revenues in the amount of $3,036,129,000. Nicor Ex. 11.1, Sched. C-1, Column D. According to Mr. Gorenz, the 2.25% rate will more closely reflect test year conditions than the propositions made by either Staff or the AG/CUB. Nicor Exs. 26.0 at 36-38; 45.0 at 6-8.

Nicor witness Mr. Kirby testified that the amount of charge-offs due to uncollectible accounts has been increasing because, increasingly, customers are not paying their bills. Customers' bills are higher due to higher prices for natural gas. Also, according to Mr. Kirby, the current "deteriorating" economic conditions, such as rising foreclosure rates and bankruptcies, have contributed to this increase in uncollectible accounts. In his opinion, these charge-offs will continue to rise through the test year. Nicor Ex. 6.0 at 15-17.

Mr. Kirby further posited that through August of 2008, Nicor disconnected 67,300 customers for non-payment. By the end of 2008, it was estimated that Nicor would disconnect almost 80,000 customers. Mr. Kirby stated that Nicor will probably have to disconnect well-over 80,000 customers in 2009. Nicor Ex. 21.0 at 20.

He averred that Nicor has become extremely aggressive in its efforts to reduce the rate of increase in past due accounts. It has implemented several programs to decrease the amount of uncollectible accounts. Nicor recently implemented a program to increase recoveries from customers who voluntarily disconnect their service when moving out of a house or business in Nicor's territory. It involves using a credit score from Experian, a credit reporting agency, and then, using different collection methods based on the customer's risk profile. *Id.* at 20.

Also, Nicor has a program that has improved its effectiveness in identifying customers who are at a higher risk of not paying their bills. This technology was "phased in" in early 2008. Use of this technology has resulted in Nicor disconnecting higher-risk customers at a sooner time than the time at which Nicor previously disconnected its customers. Earlier disconnection has reduced Nicor's charge-offs and uncollectible expense. Additionally, in 2006, Nicor began a program whereby it implemented a series of automated phone campaigns that target customers at various stages in the collection progress. This new program has increased collection and, it has reduced the need to disconnect some of the customers that Nicor would have disconnected in the past. *Id.* at 17, 19-20.

Mr. Kirby pointed out, however, that disconnecting a customer does not guarantee collection of a debt. On average, 30% to 35% of accounts that are disconnected for non-payment are never paid and, therefore, they end up being charged off as an uncollectible account. Also, disconnecting a customer for non-payment, which is a last resort, is very costly to Nicor. *Id.* at 18, 19.

b. Staff's Position

Staff witness Ms. Hathhorn proposed to lower Nicor's uncollectible accounts expense from 2.25% to 2.02%. This proposal is based on actual numbers from 2008, for the first five months, and seven months of projected figures, and Nicor's most recent uncollectible expense forecast, as of July 3, 2008, which is 2.00%. In Ms. Hathhorn's opinion, this 2.02% rate is appropriate to address Nicor's concerns regarding the economic uncertainties and volatile gas markets. This is so, she stated, because her proposal is nearly identical to Nicor's 2008 rate of uncollectible accounts. Ms. Hathhorn stated that her recommended 2.02% will also provide Nicor with relief from the 1.4% rate that is presently included in Nicor's base rates for uncollectible accounts. Staff Ex. 2.0 at 10-11.

She stated that Nicor's 2008 budgeted charge-offs includes a 33% increase to account for the impact of the weakened economy and the higher cost of natural gas. According to Ms. Hathhorn, Nicor did not demonstrate why these charge-offs should be increased another 25% based on those same contingency factors, or that such a large contingency factor is reasonable. Staff Ex. 15.0 at 8-9. Staff Reply Brief at 11.

Ms. Hathhorn further testified that, while she agreed with AG/CUB witness Mr. Effron's recommendation that an adjustment is necessary, in her opinion, her methodology is more accurate than that of Mr. Effron. This is so, she stated, because his adjustment, which reduces Nicor's uncollectible accounts expense to 1.80%, appears to give no weight to Nicor's 2008 actual activity. He also treated 2007 activity as an "outlier." Staff Ex. 15.0 at 9.

c. The AG/CUB Position

AG/CUB witness Mr. Effron proposed to use 1.80% as the appropriate percentage to calculate uncollectible expense. Mr. Effron testified that this percentage more accurately reflects Nicor's actual experience. Using an averaging methodology of two years, which, he stated, is a "more than adequate" representation of any upward trend in uncollectible accounts, he proposed that Nicor's uncollectible expense should be reduced by $13,265,000. AG/CUB Ex. 1.0 at 22-25.

Mr. Effron further testified that in other cases, the Commission has used averages of previous years to determine the amount of uncollectible accounts that a utility will experience. For example, in the recent Ameren Utilities case, Docket 07-0585, the pro forma test year uncollectible accounts rates were based on three-year averages of net charge-offs to current year revenues. In that case, the Commission explicitly referred to the use of a three-year average as a means to address an upward trend in uncollectible accounts. Mr. Effron acknowledged that Nicor is using a future test year, but he stated that Nicor is disregarding its actual experience in recent years. AG/CUB Ex. 4.0 at 10-11.

Mr. Effron analyzed Nicor's actual ratio of net charge-offs to revenues for previous years. He noted that Nicor's charge-off rate in 2004 was 1.37%. For 2005, it was 1.38%. The charge-off rate for 2006 decreased to 1.23%. He acknowledged that Nicor's charge-off rate jumped to 2.18% in 2007, but, he concluded that this jump did not establish the existence of a trend. Instead, Nicor's 2007 rate of charge-offs is an "outlier." AG/CUB Ex. 1.0 at 23; CUB Initial Brief at 10.

d. Analysis and Conclusions

We agree with Staff and Nicor that Mr. Effron's proposed amount for uncollectible accounts expense is too low. We note at the outset that Nicor is using a future test year here, which, necessarily, projects what will occur in that year. Because the recent Ameren Illinois rate cases did not involve use of a future test year, what was done in that Docket, Docket 07-0585, is not determinative.

Moreover, recent events in the past few months make it clear that the economy in the United States, indeed, in many parts of the world, is not the same as it was in previous years. We would be remiss if we did not pay attention to the state of the economy as it exists now. We also note that Ms. Hathhorn stated that Nicor's present rate of uncollectible accounts expense is just too low, given the present rate of uncollectible accounts that Nicor is currently experiencing. We note that Mr. Effron's proposal, 1.80%, is close to the accounting treatment (from Nicor's last rate case) that Nicor is currently receiving for uncollectible accounts expense, which is 1.4%. Mr. Effron's proposal, therefore, does not appear to encompass Nicor's current economic situation.

We additionally note that Mr. Effron's conclusion is not based upon information regarding Nicor's rate of uncollectible accounts from 2008. He also views Nicor's 2007 information regarding this issue as an "outlier."[3]

However, the record does not support Nicor's proposed uncollectible account expense percentage of 2.25%. While Nicor has provided evidence indicating that the amount of uncollectible accounts it experiences has risen, at this time, there is no indication that it will continue to rise, or that it will continue to rise at the rate that Nicor projects. While we acknowledge that the current economic climate is unsettled, there is also no indication, at this time, that the current high rate of foreclosures, bankruptcies, etc., in the United States will continue long into the future, or, that it will continue to increase.

We also note that Nicor's testimony indicates that it has pursued an aggressive program to collect the payment that is due it. Some of these programs, which Nicor touts as highly successful, are newly-implemented. Logically, then, Nicor has yet to reap the full benefits of these programs. Nicor's evidence as to what it has implemented to increase timely collection of funds due it is some indicia that it will not suffer financially, in the future, as much as it claims. We conclude that Ms. Hathhorn's proposed 2.02%, which upwardly adjusts Nicor's uncollectible accounts expense from that which Nicor is currently experiencing, acknowledges the effect of the rising cost of natural gas, the overall bad circumstances regarding the world-wide economy, and the fact that percentage allowed for uncollectible accounts in Nicor's previous rate case is too low, given the present rate of uncollectible expense that Nicor is experiencing. Ms. Hathhorn's proposal allows Nicor an increase, but, at the same time, it ensures that ratepayers will not be paying, unnecessarily, for a projection in uncollectible accounts expense that is inaccurately high. We therefore conclude that Staff's proposal is reasonable and hereby adopted.

3. Rate Case Expense

The amount of rate case expense Nicor seeks is not contested. However, Staff witness Ms. Jones proposed to amortize the recovery of rate case expense over a four-year period, instead of Nicor's proposed three-year period of amortization. The difference between Nicor's three-year amortization period and Staff's four year amortization period is a $542,000 reduction to Nicor's annual revenue.[4]

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[3] In its Initial Brief, the AG implied that Mr. Effron analyzed Nicor's 2008 actual charge-offs (uncollectible accounts). AG Initial Brief at 15. Mr. Effron, however, did not analyze Nicor's actual charge-offs; he analyzed Nicor's projected rate of charge-offs for 2008. *Id.*

[4] Staff witness Ms. Jones proposed an adjustment to rate case expense to decrease the amount of unamortized rate case expense from Nicor's 2004 rate case that will be included in the new rates set in this proceeding. This adjustment accounts for an additional three months of amortization that will have

a. Staff's Position

Staff witness Ms. Jones testified that Nicor's proposed Riders VBA (Volume-Balancing Adjustment) and EEP (Energy Efficiency Plan) are four-year pilot programs, which suggests that it will be at least 4 years before Nicor files another rate case. Staff reasons that the goal, when determining an amortization period, is to select a time period that allows a utility to recover the rate case expense approved by the Commission before its next rate proceeding. There is a risk to the ratepayer if the amortization period is too short. If a utility initiates its next rate proceeding before it has fully recovered the previously-approved rate case expense, the unamortized portion of rate case expense can be included in the new proceeding, which in fact was done here. However, Staff continued, if a utility exceeds the selected amortization period before it files its next rate case, it will over-recover rate case expense and there is no mechanism for returning the over-recovered amount to ratepayers. Staff noted that Nicor has a history of having long periods of time between filing rate cases. Nicor's previous rate cases were filed in 1981, 1987, 1995 and 2004. Staff Initial Brief at 29-30.

b. Nicor's Position

Mr. Gorenz testified that Nicor's management chose a three-year amortization period for rate case expense because the time period between the previous rate case filing and the current rate case filing was approximately three years. Based upon the current deteriorating economic environment, sustained high market prices for natural gas, and the high cost of labor and materials, he stated that there is an increased likelihood of shorter periods between rate cases in the future. He further testified that if this Commission approves Rider VBA, this may reduce the likelihood that natural gas deliveries would be a "significant driver" for Nicor to file a rate case. He acknowledged that therefore, approval of Rider VBA could have a positive impact on extending the time period for filing a new case. Nicor Ex. 26.0 at 39- 40.

c. Analysis and Conclusions

It is true that the last interval between rate cases for Nicor was approximately three years. However, the last interval between rate cases is not typical. As Staff points out, given Nicor's overall history, a three-year period for amortizing rate case expense is unusually short. Moreover, Mr. Gorenz' generalized statements that the economy in the United States is weak and that the costs of labor and materials are rising, without more, does not establish that Nicor will be in need of a rate increase in three years.

There is also a risk to ratepayers in amortizing rate case expense over a period of time that is too short, as, there is no mechanism with which it can be recuperated. On the other hand, if Nicor files a rate case before the end of the four-year amortization period, Nicor can include the unamortized portion in rate case expense in the new proceeding. Thus, Nicor would not be harmed by amortizing rate case expense over

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been recovered through existing rates by the time the new rates take effect. Staff Ex. 3.0 at 3-4. The amount at issue is $112,000. Nicor accepted this adjustment. Nicor Initial Brief at 25.

one additional year (four years as opposed to three years). Therefore, we conclude that Ms. Jones' proposal to amortize rate case expense over four years should be adopted.

4. Payroll/Headcount

Nicor's 2009 test year Payroll/Headcount Expense is $97,545,000. AG/CUB seek to reduce its payroll/headcount expenses by $2,602,000. Staff maintains that the Company's test year headcount is reasonable.

a. Nicor's Position

Nicor argued that, because it has met its burden of establishing that its Payroll Expense is both reasonable and will be prudently incurred, its 2009 test year Payroll Expense should be approved. It further stated that the AG/CUB's proposed adjustment to its test year Payroll Expense is unwarranted, it leads to an unreasonable result, and should be rejected. Nicor Initial Brief at 36-38.

Nicor witness Mr. D'Alessandro presented testimony regarding Nicor's headcount needs, its reasons for position vacancies and the impact of overtime, contractors and consultants on the budgeted headcount equivalents. Nicor Ex. 18.0 at 12-14. Mr. D'Alessandro testified that the impact of AG/CUB witness Mr. Effron's proposal is to reduce the average headcount for 2009 to 2,224 which results in a $2,602,000 reduction in Payroll Expense. Mr. D'Alessandro averred that the Company's actual employee level at the end of October 2008 was 2,230. He found that Mr. Effron's proposed reduction is below actual 2008 levels. Nicor Ex. 37.0 at 14-16; Nicor Initial Brief at 37.

Mr. D'Alessandro argued that much of the variance in actual versus authorized headcount is related to positions that, while currently unfilled by additional headcount, encompass work that is currently being performed by overtime work and contractors. This, he maintained, amounts to the equivalent of 78 employees. Mr. D'Alessandro averred that Nicor is currently incurring unbudgeted overtime and contractor expenses to meet the workload stemming from present employee vacancies. Nicor Ex. 18.0 at 12-14, Nicor Initial Brief at 37.

The Company also argued that even AG/CUB allows for normal system growth within its Payroll Expense. The Company concludes that the AG/CUB recommended headcount reduction, resulting in a recommended negative growth rate from 2008 to 2009, is unreasonable.

b. The AG/CUB Position

AG/CUB contended that Nicor forecasts a test year payroll expense of $97,545,000, which is an approximately 12% increase over the actual payroll expense in 2007. They maintained that in its projection, the Company has assumed that the employee count would increase from 2,130 as of the end of 2007 to an average of 2,325 in the 2009 test year. AG/CUB stated that the actual cost increases are the result of the Company's assumption that all authorized positions would be filled in the test year. AG Initial Brief at 16.

AG/CUB argued that the problem with this calculation is that almost never has Nicor actually had employees in all of the authorized positions. AG/CUB maintain that only in January of 2008 did the figures match. AG/CUB continued that the number of actual employees is normally noticeably below the number of authorized positions. They argued that while the number of employees in 2008 has increased somewhat from the number of employees in the corresponding months in 2007, the actual number of employees is still less then the full number of authorized employees forecasted by the Company. AG/CUB Ex. 1.1, Schedule C-2.1. AG/CUB concluded that the Company has not cited an occasion where the actual employee complement has been equal to the number of authorized positions, and there is little reason to believe that this situation will change in the 2009 test year. AG Initial Brief at 17.

Mr. Effron's adjustment reduces the forecasted test year operation and maintenance expense by $2,602,000. AG/CUB Exhibit 4.1, Schedule C-2.1; AG Initial Brief at 17. He proposed to reduce the headcount by 106 from the average number of employees for 2009. AG/CUB also noted that this adjustment is exclusive of the AG's proposed adjustments to Accounts 874 and 903, discussed in parts 5 and 6 of Section V infra, and that the Commission should also then make a related adjustment to payroll taxes, and reduce the Company's expenses there by $199,000. *Id.*

AG/CUB also argued that the forecasted test year payroll expense for the 2009 test year represents an increase of approximately 12% over the actual payroll expense in 2007, or nearly 6% per year, as testified to by Mr. Effron. The actual payroll expense in 2007, the most recent calendar year for which actual information is available, was $87,096,000. They maintained that it is evident that the Company's forecasted increase in the number of employees from December 2007 to January 2008 did not take place. CUB Initial Brief at 11-12.

c. Staff's Position

Staff witness Hathhorn disagreed with Mr. Effron's proposed adjustment to payroll expense and opposes adopting the AG's payroll expense adjustment. AG/CUB Ex. 1.0 at 18-21; Staff Ex. 15.0 at 12. Staff argued that its review of Nicor Ex. 18.0, its supporting work paper, and additional discovery regarding that work paper resulted in a conclusion that corroborates Nicor' position that its test year headcount is reasonable. Staff Ex. 15.0 at 12; Staff Initial Brief at 30.

d. Analysis and Conclusions

The AG/CUB propose to cut the Company's payroll expense, based upon the fact that authorized positions remain unfilled. Nicor argues that, much of the variance in actual versus authorized headcount is related to positions that, while currently unfilled by additional headcount, encompass work that is currently being performed by overtime work and contractors. AG/CUB assert that the real basis for comparison is the difference between the Company's projected headcount and its actual headcount in prior years and not the total workload. In sum, AG/CUB proposes to reduce the headcount by 106 and the Company asserts that the work of 78 employees is being performed by overtime work and contractors.

The Commission agrees with Company and Staff and finds that Nicor has met its burden of establishing that its' Payroll Expense is both reasonable and will be prudently incurred. The Commission adopts the Company's $97,545,000 2009 test year Payroll/Headcount Expense.

5. Mains & Services Expenses

Nicor included $23,768,000 for test year Mains and Services Expenses. This amount is a $5,156,000 increase to this account. AG/CUB witness Effron proposed to reduce Mains and Services Expenses by $1,352,000. CUB Initial Brief at 12.

a. Staff's Position

Staff witness Mr. Ostrander testified that, in his opinion, the reasons Nicor articulated for this increase were valid. In his opinion, Mr. Effron's adjustment is not necessary. Staff Ex.17. 0 at 8.

b. The AG/CUB Position

AG/CUB witness Mr. Effron testified that Nicor did not identify any particular factors that would explain Nicor's proposed increase, which is 28% over Nicor's actual Mains and Services Expenses for 2007. He proposed to limit the increase in expense to 5% per year, concluding that this is "more than adequate" to allow for inflation and normal growth. AG/CUB Exs. 1.0 at 25-26; Ex. 4.1, Sched. C-2. The AG/CUB seek a reduction to the test year Mains and Services Expenses in the amount of $1,352,000. CUB Initial Brief at 12.

c. Nicor's Position

Mr. McCain testified that the increase to the amount Mains and Services Expenses requested is primarily due to increased labor costs in the amount of $ $1,800,000. Also, there was an increase in contractor cost in the amount of $1,300,000.[5] Nicor Ex. 20.0 at 10. The increase in labor costs was due to an hourly wage increase for some union employees. There were also increases in costs due to employee job training expenses related to environmental compliance and cost increases related to filling management vacancies. *Id.*

Mr. McCain further testified that there were two primary factors leading to the increase in contractor costs. Locating contractor volume increased by 1% in 2008 and it will increase by 2% in 2009, based on historical experience and projected construction activity. Also, there was a 1.4% increase in locating contractor cost per unit, based on existing contracts. Further, there was a 15.8% increase in JULIE administrative fees;

[5] Mr. McCain also testified that there was a reclassification of costs between prime accounts in the amount of $1,896,000. Nicor Ex. 20 at 10. Mr. Effron accepted this and his $1,352,000 adjustment to mains and services expenses represents a reduction to his original adjustment, taking this reclassification into account. CUB Initial Brief at 12-13.

these fees are assessed to all members of JULIE's "One Call Center," including Nicor. [6] *Id.* at 11.

d. Analysis and Conclusions

We agree with Staff's and Nicor's contention that the test year Mains and Services Expenses should not be reduced. We disagree with Mr. Effron's assertion that Nicor did not substantiate its claim that an increase to Mains and Services Expenses is warranted. As is set forth above, Nicor set forth several legitimate reasons for the increase in the amount of Mains and Services Expense that it requests. There also is no evidence that the reasons that Nicor articulated for its proposed increase are untrue or invalid. Moreover, Mr. Effron's adjustment does not appear to contemplate that Nicor had increased labor costs, and, it had increases in several other costs, such as, increased JULIE fees, and, an increase in employee training costs. His proposed adjustment, therefore, does not appear to be reasonable. We find that Nicor has established that its proposed Mains and Services Expense is reasonable and it is hereby approved.

6. Customer Records And Collection Expenses

This account includes the costs associated with customer billing, accounting, collection and records. Nicor seeks $37,647,000 in customer records and collection expense for the 2009 test year. AG/CUB propose an adjustment to this figure in the amount of $3,035,000. AG/CUB Ex. 1.0 at 26.

a. Nicor's Position

Nicor witness Mr. Kirby explained the major components of Customer Care Expenses and Account 903 Expenses, which are Customer Accounts Expense, Customer Service and Informational Expenses and Sales Expenses. He testified that the amount of Nicor's customer service calls and e-mails has been volatile and unpredictable over the last few years, due to the rise in gas costs, as well as an increase in collection activities and heightened customer service demands. Nicor Ex. 6.0 at 9. Another major cost component is collections expenses, including labor costs and Nicor's use of collection agencies. Mr. Kirby testified that this cost component has increased significantly as a result of the upswing in gas prices and the recent downturn in economic conditions. Nicor also experienced an increase in expenses related to the increase in the number of disconnections it is experiencing due to non-payment. *Id.* at 10.

Mr. Kirby also testified as to some of Nicor's specific cost increases. An increase in the amount of $300,000 to Field Operations Dispatching is due to the addition of one manager, payroll increases for the current staff and an increase in clerical overtime

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[6] JULIE, Inc. (The Joint Utility Locating Information for Excavators) is a not-for-profit corporation that provides homeowners and professional excavators with one place to call for safe digging. (Illinois1call.com).

hours to support field efforts. Nicor Ex. 21.0 at 9. An increase in the amount of approximately $1,570,000 to Credit, Collections and Field Collections is for six new staff members and an additional contractor. This increase, in Mr. Kirby's opinion, is critical to support the various programs and related actions that are necessary to control the increase in charge-offs and to process customer payments. Nicor Ex. 6.0 at 10.

Mr. Kirby stated that there was also an increase of approximately $1,760,000 in expenses for customer contact, Nicor's Customer Call Center and related activities. Fluctuating and increasingly high gas costs have resulted in more customer calls and other types of customer inquiries. In his opinion, it is likely that this increase in customer inquires will continue. Also, Nicor has experienced increased credit and collection activities, as well as an increase in the number of customer calls, correspondence and like interaction. He further averred that an additional $2,300,000 is needed for corporate postage. This is due, in part, to the fact that Nicor is eliminating its bi-monthly billing programs. Also, approximately $800,000 of this figure is due to the increase in the cost of postage. *Id.* at 11.

Mr. Kirby also stated that an increase in the amount of approximately $930,000 in expense to billing services, special services, gas transportation and billing quality assurance includes three new staff members, which became necessary when Nicor eliminated its summer billing program. These programs also require additional funds for printing and handling bills in a new format. Finally, he stated that approximately $680,000 is needed for the increase in fuel and vehicle costs for the Customer Care function. *Id.* at 12.

b. Staff's Position

Staff witness Mr. Kahle disagreed with Mr. Effron's proposed adjustment. He stated that the AG/CUB adjustment is based on Mr. Effron's projection of an expected increase from normal inflation and system growth, after adding $1.4 million in billing costs. Mr. Effron projected this increase because he did not think that Nicor had adequately explained the need for Nicor's entire forecasted increase. However, during a field visit to Nicor, Nicor's staff provided Mr. Kahle with an analysis of Nicor's proposed increases to Customer Records and Collections Expenses. Mr. Kahle discussed the various increases with personnel at Nicor, such as the higher cost of gasoline, additional postage, additional staff and other expenses. After reviewing the analysis that Nicor personnel provided to him and discussing it with Nicor personnel, Mr. Kahle determined that no adjustment is necessary. Staff Ex. 14.0 at 12-13.

c. The AG/CUB Position

AG/CUB witness Mr. Effron stated that Nicor's forecast for customer records and collection expenses is significantly higher than what Nicor's actual customer records and collections expenses was in previous years. For example, the expenses charged to this account in 2006 were $31,127,000, and in 2007, these expenses were $30,061,000. Nicor's 2009 forecast for this expense increased in the amount of $7,586,000, or, 25% over the actual expenses that Nicor incurred in 2007. AG/CUB Ex. 1.0 at 26.

Mr. Effron opined that the $1.4 million that Nicor allocated to its proposed increase in postage is reasonable. However, in his opinion, the remainder of the increase appears to be in excess of what would be expected from normal inflation and system growth. He opined that an annual growth rate of 5% per year should be more than adequate to allow for inflation and normal system growth from 2007 to 2009. Mr. Effron proposed to adjust the test year forecast by beginning with Nicor's actual 2007 expenses as a base, and then, he increased that amount by $1,400,000 to allow for additional billing (postage) costs. Escalating the remainder of Nicor's projected costs by 5% per year results in an adjusted figure in the amount of $34,612,000. *Id.* at 27; AG Initial Brief at 19.

d. Analysis and Conclusions

We agree with Staff and Nicor that no adjustment to the amount Nicor seeks for Customer Records and Collections Expense is warranted. Staff witness Mr. Kahle's testimony establishes that he reviewed the bases, upon which, Nicor justifies its need for an increase to Customer Records and Collections Expenses. He concluded, after this review, that the amount of Nicor's requested increase is justified. Also, Mr. Kirby's testimony establishes that a large portion of this increase is directly or indirectly related to the increase in collection activities that Nicor is experiencing, due to the economic downturn and the rising price of natural gas. His testimony also established that Nicor is experiencing various increases in its billing costs, such as postage or the increase in costs due to elimination of Nicor's bi-monthly billing program.

7. Charitable Contributions

a. Aurora Foundation

Nicor seeks to have its $100,000 contribution to the Aurora Foundation allowed as a Charitable Contribution Expense. Staff recommended disallowing the entire amount, which the AG supported.

i. Nicor's Position

Nicor witness Bacidore testified that the Aurora Foundation is a charitable organization that provides merit-based scholarships to children of Company employees. She testified that Section 9-227 of the Public Utility Act (the "PUA") allows the Commission to consider such donations as a recoverable expense and it prohibits the Commission from disallowing such donations by rule. 220 ILCS 5/9-227; Nicor Initial Brief at 41-42. She stated that the fact that the scholarships are available only to children of Company employees does not place the contributions beyond the scope of Section 9-227. Ms. Bacidore averred that Staff's proposed adjustment should be rejected because the Company's donations to the Aurora Foundation are for the recognized charitable purpose of education. Nicor Ex.22.0 at 2-4.

Ms. Bacidore also testified that a merit scholarship plan does not conflict with the charitable purpose served by awarding the scholarships. She maintained that the scholarships promote education by encouraging potential recipients to achieve the academic standing necessary to qualify for the scholarships. Ms. Bacidore argued that the charitable purpose of promoting education does not disappear because Nicor hopes that the scholarships may help attract and retain a qualified work force. Nicor Ex. 41.0 at 4.

The Company further contended that Staff makes no claim that the donations to the Aurora Foundation are in any way excessive.

ii. Staff's Position

Staff witness Ms. Jones objected to recovery of $100,000 in charitable contributions to the Aurora Foundation on the grounds that the contributions are a benefit to Company employees. She argued that Nicor's contribution specifically funds the Nicor Gas Scholarship Fund, which is administered by the Aurora Foundation, and that these scholarship benefits are limited to the children of Company employees. Staff Ex. 3.0 at 6-7; Staff Initial Brief at 31. The contribution is not for the public welfare or for charitable purposes as is required for recovery by Section 9-227 of the PUA. She concluded that therefore, this contribution should not be recovered from ratepayers.

She testified that giving money for the scholarships to the Aurora Foundation does not necessarily make it a charitable contribution, since the Aurora Foundation is the administrator of the Nicor Gas Scholarship Fund. She noted that the Company's Contribution Guidelines specifically state that grants will not be made to foundations. Staff concluded that money given for these scholarships is not for the public welfare or for charitable purposes, as required for recovery under Section 9-227 of the PUA. Staff Ex. 16.0 at 4-6.

iii. Analysis and Conclusions

The Commission finds that the evidence shows that the donations to the Aurora Foundation are not reasonable and charitable in nature. We find that the fact that eligibility for the scholarships awarded by the Aurora Foundation is limited to Company employees defeats the charitable nature of the donations. The fact that Nicor hopes that its employees or prospective employees might view the scholarship plan as an enticement to join or remain with the Company defeats the charitable purpose of the donations to the scholarship fund.

For these reasons, the Commission adopts Staff and the AG's proposal to remove $100,000 from operating expense.

b. Salvation Army – Chicago

Nicor seeks to have its matching contribution of $220,000 for its Sharing Program with the Salvation Army allowed as a Charitable Contribution Expense. Staff recommends disallowing the entire amount.

i. Nicor's Position

Nicor witness Mr. Kirby testified that Nicor's Sharing Program is a long-standing program with demonstrated benefits to financially-challenged customers. Mr. Kirby maintained that the Sharing Program is similar to "add a dollar"-type programs offered by other Illinois utilities, in that the Company matches customer contributions added to the amount of that customer's bill. Mr. Kirby questioned the disallowance of Sharing Program contributions when similar programs were listed as a Charitable Contributions expense by other utilities. Nicor Ex. 21.0 at 13-15, Ex. 40.0 at 4-6. He stated that there is no claim that the matching contributions and administrative fees under the program are not in furtherance of a charitable purpose or that the amount of the contribution is unreasonable. Mr. Kirby concluded that the Company has established that its charitable contributions in support of this program are both reasonable in amount and prudently incurred in furtherance of a charitable purpose. Nicor Initial Brief at 42-43.

Mr. Kirby argued that disallowing recovery for the contribution of matching funds to the Salvation Army, while allowing other charitable contribution expenses, creates a disincentive for utilities to continue to offer the program. While most of the major utilities that have had rate cases in recent months have a similar add-a-dollar program, it appears that the Company's contributions are the only ones subject to a proposed adjustment. Mr. Kirby averred that contributions to Peoples Gas' Share the Warmth program totaling $400,000 were allowed as operating expenses in the 2007 Peoples Gas Rate Case. *See* 2007 Peoples Gas Rate Case Order; Part 285.3070 filing, Sched. C-7, p. 11-13, n. 3; Nicor Initial Brief at 43.

Nicor disagreed with Staff's arguments that allowing this expense would amount to customers unfairly paying once through the direct contribution and then again through base rates. It argued that its customers are motivated by the ease of the donation to the program and by the fact that each dollar the customer contributes will result in an additional dollar being pledged to help those in need of assistance in paying their gas bill.

ii. Staff's Position

Staff witness Ms. Jones stated that the contribution represents the Company's match of contributions from Company customers and employees to the Nicor Gas Sharing Program which is administered by the Salvation Army-Chicago. Ms. Jones testified that this cost should be paid by shareholders; otherwise, ratepayers are paying once through direct contributions and again through base rates. She stated that the contribution is not intended for a charitable contribution outside of the agency in need of help, but, it is targeted specifically for assistance to certain of the Company's ratepayers in paying their bills. By including the contribution in the test year, the Company is shifting the funding of its matching contribution to ratepayers. Its shareholders would take no responsibility for providing any of the Sharing Program funds to assist Nicor's fixed and low income customers who are having difficulty meeting their obligations to pay their gas bills. Ms. Jones maintained that to allow Nicor to include amounts contributed as a match to its customers' donations amounts to ratepayers paying twice for their generosity. Staff Ex. 16.0 at 8-9; Staff Initial Brief at 32-33.

Ms. Jones further argued that the failure of Staff to raise the issue of whether the Peoples Gas Share the Warmth program was recoverable in previous cases does not bar Staff from raising it here. Staff stated that the Commission excluded matching contributions from operating expenses in Docket 93-0183 (Illinois Power Company) and Docket 95-0076 (Illinois-American Water Company). Staff Ex. 3.0 at 7-9; Staff Initial Brief at 32-33.

iii. Analysis and Conclusions

We conclude that the Company has established that its charitable contributions in support of the Salvation Army Sharing program are both reasonable in amount and prudently incurred in furtherance of a charitable purpose. The fact that its contributions are matching funds does not diminish the charitable nature of the contribution or remove the donation from the purview of Section 9-227 of the Act. We accept Nicor's assurances that it is committed to fully supporting the program, in particular, its assurances that it will not seek a refund of these donated funds, and find that its contributions to the Salvation Army Sharing Program should be allowed.

8. Depreciation and Amortization Expenses

Nicor's proposed amount for depreciation and amortization expenses was revised in testimony to $176,254,000. While there is disagreement between Nicor, Staff and the AG/CUB regarding proposed rate base adjustments, Nicor and Staff agree as to the calculations necessary to adjust depreciation and amortization expense. Nicor Ex. 26.0 at 45-46; Staff Ex. 17.0 at 3.

9. Income Taxes

To the extent that Nicor does not agree with adjustments proposed by Staff and the AG/CUB to Nicor's revenue requirement, it does not agree with the derivative adjustment to Income Tax Expense. Nicor Ex. 26.0 at 48. However, there is no issue here as to methodology. Nicor Initial Brief at 44.

10. Taxes Other Than Income Taxes

Nicor witness Mr. Gorenz adjusted Nicor's figure for Taxes Other Than Income Taxes to $20,251,000. This adjustment reflects three proposed adjustments from Staff and the AG/CUB. Nicor Ex. 26.0 at 47-48. The Commission accepts this adjustment.

11. Interest Synchronization

There is no issue in this case as to methodology. Nicor Ex. 26.0 at 48-49.

OVERALL CONCLUSION ON OPERATING EXPENSE STATEMENT

Based on the gas utility operating expense statement as originally proposed by Nicor Gas and the adjustments to operating revenues and expenses as summarized above, the total gas utility operating expenses for Nicor Gas approved for purposes of this proceeding are $535,265,000. The operating income statement may be summarized as follows:

Nicor Gas Approved Operating Statement (in thousands)

Description	Amount
Base Rates Revenues	$ 616,262
PGA Revenues	-
ECR Revenues (Coal Tar)	-
Other Revenues	20,304
Total Operating Revenue	$ 636,566
Uncollectible Expense	62,724
Cost of Gas	1,371
Storage	32,789
Transmission	5,110
Distribution	55,691
Customer Accounts	45,189
Customer Services and Informational Services	631
Sales	416
Administrative and General	99,001
Depreciation	177,830
Taxes Other Than Income	19,880
Total Operating Expense Before Income Taxes	500,633
State Income Tax	6,595
Federal Income Tax	40,534
Deferred Taxes and ITCs Net	(12,497)
Total Operating Expenses	$ 535,265
Net Operating Income	$ 101,301

The development of the overall gas utility operating expenses adopted for Nicor Gas for purposes of this proceeding is shown in Appendix A to this Order.

VI. RATE OF RETURN

A. UNCONTESTED ISSUES

1. The Embedded Cost of Long-Term Debt

No party has contested Nicor's proposed embedded cost of long-term debt of 6.80%. *See e.g.,* Nicor Ex. 24.1; Staff Ex. Sched 18.1. Nicor Initial Brief at 45. Accordingly, this amount is hereby approved.

2. The Embedded Cost of Preferred Stock

No party has contested Nicor's proposed embedded cost of preferred stock, which is 4.77%. Staff Sched. 18.1C, CUB Ex. 1.0 at 31. Accordingly, this amount is hereby approved.

B. CONTESTED ISSUES

1. Capital Structure

a. Introduction

A company uses various types of investor-supplied capital to purchase assets and operate a business. Utilities typically rely upon long-term debt and common equity, and in some instances preferred stock and short-term debt, to purchase assets and fund operations. The costs of different types of investor-supplied capital vary depending upon a multitude of factors, including the risk associated with the investment. As a result, the proportion of the different types of capital, also known as the capital structure, when combined with the costs of each different type of capital, affects the overall or weighted average cost of capital, which is the rate of return that a utility is authorized to earn on its net original cost rate base.

The Commission relies on the cost of capital standard to determine a fair rate of return. This cost, which can be determined from the overall rate of return or weighted average cost of capital, should produce sufficient earnings and cash flow when applied to the respective company's rate base at book value to: enable a company to maintain the financial integrity of its existing invested capital, maintain its creditworthiness, attract sufficient capital on competitive terms to continue to provide a source of funds for continued investment, and enable a company to continue to meet the needs of its customers.

These standards are effectively mandated by the landmark U.S. Supreme Court decisions *Bluefield Water works & Improvement Co. v. W. Va. Public Service Comm.,* 262 U.S. 679, 43 S. Ct. 674 (1923) and *Feceral Power Comm. V. Hope natural Gas co.,* 320 U.S. 391, 64 S. Ct. 281 (1944). Meeting these requirements is necessary in order for a company to effectively meet the utility services requirements of its customers and provide an adequate and reasonable return to its investors, debt holders and equity holders alike.

b. Inclusion Of Short-Term Debt

i. Nicor's Position

Nicor averred that it uses short-term debt today in the same manner as it has historically, to finance temporary items or situations, its seasonal cash requirements and not to finance its rate base assets. In short, Nicor stated that its proposed capital structure does not include short-term debt, because Nicor does not use short-term debt to finance rate base assets or to make long-term investments in rate base. Nicor asserted that its proposed capital structure mirrors the capital structures approved by the Commission in the Company's last three rate cases. Nicor argued, and Staff did not dispute, that Nicor's capital structure has helped insulate it from unfavorable market conditions and financial stress. It has also reduced Nicor's cost of debt and other costs of doing business. Nicor Initial Brief at 46-58.

Nicor objected to Staff's proposal to impute a large, short-term debt component into its capital structure for ratemaking purposes. Nicor asserted that Staff's proposed hypothetical capital structure conflicts with its actual capital structure, its use of short-term debt, both historically and today, and the Commission's determination on the short-term debt issue in the Company's last three rate cases.

Nicor witness Ruschau testified that various factors drive seasonality in cash flow at Nicor, including customer consumption patterns (mostly due to weather), revenue billing and collection patterns, natural gas storage injection/withdrawal cycles, the level of gas prices, and the timing of a variety of receipts and expenditures. Nicor stated that it uses short-term debt to help manage this variability in cash flow and to avoid the need to maintain excess amounts of permanent, more expensive long-term capital on a year-round basis. *Id.*

In opposition to Staff's position, Nicor stated that it has no short-term debt outstanding for several months every year. Specifically, Nicor has had no short-term debt outstanding for an average of five consecutive months in any year since its 2004 Rate Case. Since 1987, the period spanning Nicor's last three rate proceedings, Nicor has had no short-term debt outstanding for an average of four consecutive months in any year. Nicor stated that it will have no short-term debt outstanding for three months during the 2009 test year.

According to Nicor, Staff's proposal to impute $236 million of short-term debt into the Company's capital structure would degrade Nicor's' credit profile, weaken its financial condition, and increase its financial risk. Over time, Mr. Ruschau testified that degradation of the Company's financial condition and credit profile could result in higher long-term and short-term interest expense, higher financing costs, and higher costs to provide credit support in various forms to counterparties, including its natural gas suppliers. *Id.*

Nicor disputed Staff's argument that a dramatically more leveraged capital structure would not create risk. Nicor maintained that Staff takes the position that Nicor is, or by implication, should be, financing approximately 18% of its rate base with short-term debt. If Nicor actually were to finance its fixed investments in such a manner, the debt-heavy capital structure would cause greater earnings instability, due to the high degree of volatility in short-term interest rates and financial uncertainty regarding long-term availability of short-term funds to finance long-term assets in rate base.

Nicor also disputed Staff's argument that its proposed capital structure is commensurate with a strong degree of financial strength and compares favorably with other companies in the gas distribution industry. Nicor asserted that Staff performed no analysis to support the comparability of Nicor to the companies included in the industry database that Staff employed. Staff also presented a hypothetical capital ratio analysis that attempted to forecast the effect of Staff's proposed revenue requirement on Moody's pro forma 2009 credit ratios for Nicor. Nicor maintained that Staff's credit ratio analysis does not properly reflect the applicable credit rating methodology or the qualitative ratings factors considered by the rating agencies. It also, according to Nicor, sharply underestimates the negative impact of Staff's proposal on the Company's credit profile.

Nicor opposed Staff's argument that, since Nicor includes assets with balances that exhibit a high degree of seasonal variation through the test year in its rate base, then, Nicor "must" be funding rate base with short-term debt. It insisted that any correlation between monthly changes in its short-term debt and cash working capital ("CWC") account balances is neither surprising nor supportive of Staff's conclusion. According to Nicor, the CWC component of rate base is not derived from the balance sheet working capital accounts that were used in Staff witness Ms. Freetly's analysis; it is also not a temporary, seasonal need. It is derived from a lead-lag study, which is the method endorsed and accepted by the Commission for determining the working capital component of a utility's rate base. Nicor argued that seasonal increases in storage are accounted for and financed mostly outside of rate base, and the Company earns no return on this temporary seasonal increase in storage inventory. In contrast, Nicor stated, the Gas in Storage asset included in rate base is based on the Company's original cost of net injections (normalized through a 13-month average, similar to other rate base assets that fluctuate through the year) and is a permanent, long-term investment supported by long-term capital. Nicor Initial Brief at 50-52.

Nicor also disputed Staff's contention that the difference between its proposed rate base and its book value capitalization implies that the Company's requested rate of return includes a "cushion" against interest rate exposure. In particular, Nicor disputed Staff's calculation of an "implied return on total capital" of 12.18%, as compared to the Company's proposed actual 9.27% overall rate of return. According to Nicor, to reach this result, Staff miscalculates its overall rate of return by basing an "implied return" on the Company's (smaller) balance sheet capitalization, rather than its (larger) rate base. Further, significant differences between rate base and capitalization are not a new phenomenon. Differences between rate base and capitalization of similar magnitude to this proceeding have existed in each of its last three rate cases. *Id.*

Finally, Nicor disputed Staff's assertion that the Company's proposed capital structure mistakenly used December 31, 2009, balances for long-term debt and preferred stock in its average 2009 capital structure proposal. Nicor insists that Nicor

Exhibit 24.1 and the work papers to that exhibit show that the amounts reflected in each component of Nicor's proposed test year capital structure represent 13-month averages.

Local Union No. 19 ("Local 19"), International Brotherhood of Electrical Workers, AFL-CIO ("the IBEW") filed its Brief on Exceptions on February 25, 2009, and adopted Nicor's position on this issue.

ii. Staff's Position

Staff contended that the primary difference amongst the parties regarding Nicor's capital structure is whether short-term debt should be included. Staff maintained that Nicor uses short-term debt to finance a portion of its rate base, and therefore, short-term debt should be included in the Company's capital structure. CUB also agreed that short-term debt should be included in Nicor's capital structure.

Staff posited that Nicor has consistently relied on short-term debt as a source of funds and it forecasts a continued need to do so. According to Staff, due to the fungible nature of capital, it is generally assumed that all assets, including assets in rate base, are financed in proportion to total capital, unless they are shown otherwise. Staff maintained that the Company has not demonstrated that short-term debt does not support rate base.

Staff averred that the long-term components of Nicor's capital structure cannot be the sole source of funding for its rate base. Staff stated that, since Nicor includes assets with balances that exhibit a high degree of seasonal variation throughout the test year in its rate base, there must be a financing source that fills the seasonal need for funds created by the Company's seasonal rate base assets. Staff averred that Nicor does have a source of funds that closely tracks the variability of those seasonal rate base assets: short-term debt. The 0.85 correlation between short-term debt and working capital indicates that Nicor relies on short-term borrowing to meet the funding needs arising from its working capital requirements. Staff further asserted that the monthly amounts of short-term debt outstanding closely track the sum of gas in storage and customer accounts receivable. According to Staff, Nicor's short-term debt balance peaks near year-end, when gas inventory also peaks and before winter revenues have been collected. As winter revenues are collected, short-term borrowing requirements decline. However, by late summer, short-term borrowing increases through the fourth quarter and the annual cycle repeats itself. Staff added that there is no short-term debt outstanding in the late spring and early summer months, due to the seasonal nature of natural gas operations. According to Staff, this variable source of funding is vital to support gas purchases and other operations until Nicor receives payment from customers. In Staff's view, short-term debt is a permanent source of seasonal funds for Nicor. Staff Initial Brief at 36-38.

Staff disputed the veracity of Nicor's assertions that including short-term debt in the capital structure for ratemaking purposes would result in a dramatically more levered capital structure, would introduce a new element of variability into the Company's earnings and rate of return, and could degrade the Company's credit profile. Staff contended that this is incorrect because Nicor's extensive reliance on short-term debt, not the inclusion of that variable cost in its capital structure, is the source of variability in its earnings. Staff asserted that the interest rates that Nicor pays on its short-term debt will vary regardless of whether the Commission includes that short-term debt in the capital structure it adopts for setting the authorized rate of return on rate base. *Id.*

According to Staff, Ms. Freetly compared her proposed common equity ratio for Nicor to the common equity ratio for the gas distribution industry. In the second quarter of 2008, the mean common equity ratio for the gas distribution industry was 50.44% with a standard deviation of 10.18%. Staff posited that its proposed common equity ratio of 46.42% compares favorably with the other companies in the gas distribution industry. Further, Staff's witness Ms. Kight-Garlisch's analysis of the effect of Staff's proposed revenue requirement on the Moody's guideline ratios concludes that Nicor's financial strength under Staff's proposed revenue requirement is commensurate with an Aa3 rating. Staff believed that its proposed capital structure is commensurate with a strong degree of financial strength and should be adopted by the Commission for the purposes of this proceeding.

Also, whether the Commission includes short-term debt in the capital structure will not affect the Company's ability to earn its authorized return as much as changes to the interest rates that it must pay on that short-term debt would have such an effect. If short-term interest rates were to rise after this rate case concludes, Nicor would be required to make higher interest payments on its short-term debt borrowings (thus impairing its ability to earn its authorized return), regardless of whether the Commission appropriately included short-term debt in Nicor's capital structure. If the Company truly believed its exposure to the variable cost of short-term debt was not manageable, Staff suggested that Nicor would have reduced its use of short-term debt. Given that Nicor continues to utilize short-term debt to support its operations, Staff opined that Nicor's rates should include that cost of capital. Staff Initial Brief at 39-42.

Staff argued that the only difference between the Company's rate of return proposal and Staff's is that by excluding short-term debt from the capital structure, Nicor is incorporating a "cushion" into its requested rate of return. Staff asserted that Nicor's solution to its exposure to interest rate risk is to charge its customers a rate of return on rate base that exceeds its cost of capital. Under Nicor's proposal, customers would pay the higher costs of long-term debt and common equity capital to cover its lower short-term debt costs. The higher a utility's rates are relative to its costs, the lower the risk that it will fail to meet its required rate of return. Staff opined that rate regulation should not have lowest possible risk to utility investors as its sole objective – that would only lead to unjustly and unreasonably high rates. In Staff's view, rate regulation should seek to establish rates that compensate a company and its investors for its reasonable costs, including a reasonable rate of return on investment. Staff proposed to include short-term debt in the capital structure, because, in Staff's opinion, this accurately reflects the cost of capital to apply to rate base. *Id.*

According to Staff, the Company's proposed rate base exceeds the long-term capital in its proposed capital structure by nearly $400 million, *i.e.,* the Company's proposed rate base is 131% of its proposed long-term capitalization. Staff asserted that the effective rate of return on total capital, under Nicor's proposal, would actually be 12.18%. Staff stated that under the Company's proposal, customers would provide a 12.18% return to all investors even though the Company estimates its cost of capital to be 9.27%. Since any return in excess of the cost of capital goes to common equity investors, Staff contended that the rate of return on common equity exceeds the cost of common equity by an even larger amount. Under the Company's proposal, customers would provide common equity investors a 16.28% return even though Nicor estimates that its cost of equity equals 11.15%.

Staff concurred with the Company that rate base and capitalization are not required to be equal because some balance sheet items are excluded from rate base by practice or law and others are measured using different techniques. Staff argued, however, that it is a basic finance tenet that all assets must have a source of funding. Therefore, Staff contended, a large discrepancy between rate base and capitalization proposals merits investigation because it could indicate a deficiency in either rate base or capital structure or both. Staff maintained that Nicor has refused to perform an investigation into its rate base and capital structure discrepancy. In Staff's investigation of this difference, however, Ms. Freetly found that the balances of some of the components of Nicor's rate base proposal fluctuate with the seasons and that fluctuation is highly correlated with fluctuations in the Company's balance of short-term debt. Thus, Staff concluded that the large difference between Nicor's rate base and capital structure proposals is at least in part due to its exclusion of short-term debt from its proposed capital structure. *Id.*

iii. Analysis and Conclusions

In order to reasonably estimate Nicor's cost of capital, it is necessary for the Commission to determine what amount, if any, of Nicor's short-term debt is used to finance assets included in rate base. While the parties have raised numerous issues and arguments, in the Commission's view, the relevant question in this instance is to what extent, if any, Nicor uses short-term debt to finance the acquisition of assets included in the test year rate base.

The record evidence supports the conclusion that a significant amount of Nicor's short-term debt is used to finance assets included in rate base. A review of Nicor Exhibit 24.0 at 17 indicates that it routinely uses short-term debt to finance its CWC requirements. Mr. Ruschau essentially states this. He attempts, however, to justify excluding short-term debt from the capital structure on the basis that the CWC value in rate base reflects "a year-round, long-term investment that must be supported on a permanent basis," which, Nicor suggests, warrants financing the CWC with long-term capital rather than short-term debt. In reality, the CWC included in rate base results from a lead-lag study and, contrary to Nicor's suggestion, it incorporates the fact that cash requirements vary throughout the test year. A properly conducted lead-lag study takes into consideration the seasonal cash needs of a company. Contrary to Nicor's contention, there is not one CWC that is included in rate base, and a second, seasonal cash need that is not included in rate base. The value of CWC included in rate base is fundamentally no different than average rate base values of other assets that vary throughout the test year.

The record fails to demonstrate to the Commission that Nicor can or does track its use of short-term debt, or that short-term debt is used solely for purposes other than financing assets that are included in rate base. Likewise, the fact the short-term debt balance is projected to be zero during some months in the test year does not demonstrate that some portion of short-term debt is not used to finance assets included in rate base. It is clear that both Nicor's outstanding short-term debt balance, as well as the value of certain assets included in rate base, vary over time during the test year.

The Commission is aware that it has in previous rate cases excluded short-term debt from the Company's capital structure. However, this case is distinguishable in that the record evidence is not sufficiently compelling to support a conclusion that no short-term debt was used to finance rate base assets. The Commission is cognizant of current economic conditions confronting ratepayers and finds that it is even more imperative that any rate increase that is approved to be clearly and unequivocally supported by the record evidence.

In conclusion, the Commission rejects Nicor's proposition that short-term debt should be excluded from the capital structure. Additionally, the Commission finds that that the methodology employed by Staff to quantify the proportion of short-term debt that should be reflected in the capital structure is reasonable. The Commission believes that Staff's approach (which subtracts from projected monthly balances of short-term debt balances the balances of CWIP accruing AFUDC) reasonably estimates the proportion of short-term debt that Nicor uses to finance assets included in rate base. Thus, for purposes of this proceeding, a short-term debt balance of $255,640,082 is hereby adopted.

2. Long-Term Debt, Preferred Stock, and Common Equity Balances

a. Staff's Position

Staff proposed to adjust all of the components of its recommended capital structure to reflect the Commission's methodology for calculating CWIP-accruing AFUDC.[7] This assumes that short-term debt is the first source of funds for financing CWIP and that any CWIP that is not funded by short-term debt is funded proportionally by the remaining sources of capital. Nicor forecasted a higher balance of CWIP-accruing AFUDC than short-term debt during the months of April, May and June of 2009. Hence, according to Staff, the remaining balance of CWIP-accruing AFUDC is assumed to be financed by long-term debt, preferred stock and common equity according to their relative proportions to long-term capital.

Staff and Nicor agreed that the CWIP-accruing AFUDC adjustment would not be necessary if short-term debt is excluded from the capital structure. This was because in

[7] "CWIP" is Construction Work in Progress. "AFUDC" is an allowance for Funds Used During Construction. Valueline.com.

the absence of short-term debt, the CWIP-accruing AFUDC adjustment would not change the long-term debt, preferred stock or common equity ratios. Nevertheless, Staff disagreed with Nicor's assertion that, if short-term debt were included, those adjustments Staff made to the other components of Nicor's capital structure that were based on the calculation of AFUDC balances are improper. Nicor argued that CWIP-accruing AFUDC may have been funded by sources of cash other than permanent capital. According to Staff, this argument ignores the Commission's formula for calculating CWIP- accruing AFUDC, as set forth in the Uniform System of Accounts for Gas Utilities Operating in Illinois (the "USOA").

While Staff agreed that, from a theoretical perspective, one cannot identify the specific source of funds that was used to pay the cost of CWIP; Staff argued that the Commission's formula for calculating AFUDC (*i.e.*, the cost of financing CWIP) assumes that short-term debt is the first source of funds that finance CWIP. That formula further assumes that any CWIP that is 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). According to Staff, the portions of long-term debt, preferred stock and common equity that the AFUDC formula assumes is financing CWIP should be removed from the capital structure to avoid double-counting. In Staff's view, it properly allocated the remaining balance of CWIP-accruing AFUDC on the basis of the proportion of total long-term capital that each long-term capital component represents. Staff Initial Brief at 42-43.

b. Nicor's Position

Nicor asserted that for May-June of 2009, Staff subtracted proportionate amounts of long-term debt, preferred stock and common equity from the capital structure, which, Staff asserts the AFUDC formula assumes is financing CWIP. Nicor averred that these adjustments result solely from Staff's proposal to impute short-term debt into Nicor's capital structure and, therefore, are unnecessary.

c. Analysis and Conclusions

While the parties are correct that from a practical standpoint cash is fungible, this is a ratemaking proceeding and to estimate Nicor's cost of capital as accurately as possible the Commission cannot ignore the ratemaking assumptions underlying the AFUDC formula. The AFUDC formula includes assumptions regarding how CWIP is financed. It is clear to the Commission that the ratemaking assumptions regarding how CWIP is financed impacts, for ratemaking purposes, how rate base is financed. To ignore those assumptions in this proceeding would run the risk of misstating the proportion of long-term capital used to finance rate base, thereby overstating or understating the cost of capital applied to rate base. While it is not necessary that the total dollars of capital contained in the capital structure match the total dollars of rate base, in estimating the rate of return, it is important that the proportion of dollars used to finance rate base be estimated as accurately as possible.

The Commission concludes that, in this instance, Staff is correct that the assumptions underlying the AFUDC formula impact the proportion of dollars remaining to finance rate base. Based upon this conclusion and the Commission's conclusion regarding the balance of short-term debt, for the purposes of setting rates in this proceeding, the Commission adopts the following capital structure:

Source of Capital	Amount	Proportion
Short-term debt	$ 255,640,082	18.21%
Long-term debt	495,195,694	35.27%
Preferred stock	1,386,144	0.10%
Common equity	651,818,845	46.42%
Total Capital	$ 1,404,040,765	100.00%

C. COST OF DEBT AND PREFERRED STOCK

1. Cost of Short-Term Debt

a. Nicor's Position

Nicor asserted that the determination of its cost of short-term debt is not relevant because short-term debt should be excluded from the Company's capital structure. In the event that the Commission were to include short-term debt in the Company's capital structure, a more appropriate test year cost of short-term debt would be 3.72% compared to Staff's 2.50% estimate. Nicor Initial Brief at 53.

b. Staff's Position

Staff estimated Nicor's cost of short-term debt to be 2.50%. Staff stated that Nicor issues short-term debt in the form of commercial paper rated A-1+ and P-1 by S&P and Moody's, respectively. Staff also stated that the interest rate on commercial paper varies with grade and term to maturity. To estimate the cost of short-term debt, Staff converted the August 5, 2008, 2.05% discount rate on 60-day, AA non-financial commercial paper into an annual yield of 2.09%. To this yield, Staff proposes adding the bank commitment fees that Nicor incurs to maintain the bank lines of credit that support its commercial paper program. This results in a 41 basis point increase to Staff's estimate of Nicor's cost of short-term debt (2.09% + 0.41% = 2.50%). Staff Initial Brief at 44-45.

According to Staff, the Company estimates that the cost of short-term debt is 3.70%. This estimate reflects a forecasted interest rate plus bank commitment fees. Staff argues that Nicor does not borrow at the LIBOR rate; thus, the cost of short-term debt should not be set based on LIBOR rates.[8] *Id.*

[8] LIBOR is the London Interbank Offered Rate. bba.org.UK.

c. Analysis and Conclusions

The record indicates that Nicor’s actual cost of short-term borrowing is not based upon the LIBOR rate and therefore the Commission finds that the LIBOR rate should not be the basis for establishing Nicor Gas' rate of return in this proceeding. Instead, the Company's actual cost of short-term borrowing is based upon the cost of commercial paper and the rate of return on rate base should be reflective of that cost. For purposes of this proceeding, the Commission finds Staff's estimate of Nicor‘s cost of short-term debt, 2.50%, to be reasonable and it is hereby adopted.

D. **COST OF COMMON EQUITY**

1. Nicor’s Position

Nicor asserted that the Commission should adopt an 11.15% rate of return on common equity ("ROE") for purposes of determining its overall authorized rate of return. Nicor argued that it developed and presented its ROE proposal using the most recent data in the record and the same accepted calculation methodology employed in Nicor’s 2004 rate case. Nicor agreed with Staff as to the basic approach that the Commission should take in determining ROE in this proceeding. It urged the Commission to take a simple average of the results produced by DCF and CAPM cost of equity methods. Nicor Initial Brief at 54-55.

Nicor disagreed with Staff’s and CUB’s approaches to the DCF calculation, however. Nicor also objected to CUB’s position that the CAPM method should not be used in this proceeding. Nicor asserted that Staff’s and CUB’s proposals, if adopted, would push Nicor’s ROE well-below its peers’ cost of equity and the ROEs determined in every major Illinois rate case decided in the past year. Nicor urged the Commission to adopt its proposed ROE, which, it asserted, is fair and just and will permit Nicor to attract the required capital at reasonable cost.

a. Discounted Cash Flow Model

Nicor witness Dr. Makholm calculated a discounted cash flow ("DCF") cost of equity of 10.37%. Nicor stated that Dr. Makholm employed the same approach to the DCF calculation in this proceeding as the one the Commission adopted in the Company’s 2004 rate case. This approach includes the use of three different prospective measures to estimate dividend growth. To limit the contested issues, Dr. Makholm excluded Nicor’s selling and issuance expense when he updated Nicor’s DCF calculation in his rebuttal testimony. On rebuttal, Dr. Makholm also used Staff’s July 22, 2008, stock price date. Staff agreed that the eight-company peer group accurately reflects Nicor’s operating risk, although Staff excluded one utility (MGE Energy Corp.) from its DCF calculations for other reasons. CUB also used Nicor’s peer group for its DCF calculation. Nicor Initial Brief at 55.

Nicor objected to Staff’s and CUB’s lower DCF cost of equity proposals. According to the Company, the main difference between Nicor‘s and Staff’s DCF calculations is Staff’s use of a three-stage growth rate for its calculation, in contrast to

Dr. Makholm's single-stage model. A second difference separating Nicor's approach from that of both Staff and CUB is the "S*V" component of Dr. Makholm's sustainable growth rate, which, according to Nicor, accounts for future dividend growth from new issuances of stock at a premium over book value. It asserted that the actual effect of the "S*V" component on Nicor's DCF calculation is minimal. *Id.* at 56-57.

Nicor refuted Staff's proposed three-stage growth rate model for use in the DCF calculation. In particular, Nicor took issue with Staff's assumption that the overall rate of growth of the economy is a good proxy for the utility sample's long-term growth. Dr. Makholm testified that "the measured productivity of utilities of all sorts … is consistently and persistently greater than the economy as a whole." He argued that the Commission has examined the question and found that utilities generally exhibit "greater productivity growth than the economy as a whole." (Citing, *Ill. Bell Telephone Co.*, Docket 92-0448), Order at 83 (Oct. 11, 1994). Dr. Makholm testified that, while gas utilities realistically are not likely to grow in sheer size or annual throughput relative to the economy as a whole, the growth that matters for purposes of the DCF calculation is "growth in earnings." He stated that the utility industry is uniquely positioned to sustain productivity and, hence, earnings growth.

Nicor also refuted Staff's and CUB's positions regarding the "S*V" sustainable growth rate (new issuances of stock at a premium to book value). Nicor objected to Staff's assertion that Dr. Makholm failed to investigate the effect of exercised stock options on the price of the stock issued by the sample utilities, which, Staff contended, may have been issued at below-market prices. Nicor averred that Dr. Makholm investigated the largest equity issuances by the utility sample and opined that those issuances all were through public offerings at prevailing market prices. These issuances, according to Dr. Makholm, also represent almost the entirety of common stock issuances by the utility sample during the relevant period. The issuances investigated by Dr. Makholm account for 24 of the 32 basis points that Dr. Makholm included in his DCF calculation. Nicor contended that Staff's and CUB's arguments against the "S*V" term, at best, account for eight basis points.

Nicor also objected to CUB's assertion that the "S*V" term should be excluded from the Company's DCF calculation, because Nicor does not have any "concrete plans" to issue new equity. According to Nicor, the DCF analysis comes from the entire comparable group of companies, not just from Nicor, and the issuance of sizable blocks of new common shares by the group is a regular phenomenon. Nicor disputed CUB's criticism of analysts' growth rate forecasts, which, the Company asserts, provide an objective measure of investor expectations.

b. Capital Asset Pricing Model

Dr. Makholm calculated an 11.93% capital asset pricing model ("CAPM") return for purposes of the Company's ROE recommendation. As with the DCF calculation, Nicor stated that Dr. Makholm used the same CAPM calculation in this proceeding as the one the Commission adopted in the 2004 rate case. Dr. Makholm calculated Nicor's CAPM cost of equity using published and adjusted Value Line betas. Nicor objected to

Staff's approach to the CAPM analysis, which, Nicor asserts, is internally inconsistent and without support in prior Commission Orders. Nicor Initial Brief at 58-59.

First, Nicor asserted that the Commission should discard Staff's proposal to mix adjusted and unadjusted (or raw) betas for purposes of the CAPM calculation. This approach, presented in rebuttal testimony, forms the basis for Staff's recommended 10.60% CAPM cost of equity. Staff's recommended CAPM cost of equity is the lowest among the three approaches to the CAPM calculation. *Id.* at 57.

Nicor argued that Staff provided no regulatory, academic or other support for its recommended approach. According to the Company, Staff witness Kight-Garlisch acknowledged that the Commission traditionally has relied upon adjusted beta estimates for CAPM purposes. Nonetheless, Ms. Kight-Garlisch employed raw betas in her recommended CAPM calculation. She also, allegedly, equivocated that her inclusion of raw betas in Staff's CAPM calculation should not be construed as Staff's agreement that raw betas are appropriate for CAPM analysis. In fact, Ms. Kight-Garlisch was unable to identify a single proceeding in which the Commission has employed a CAPM analysis similar to the one Staff recommends here.

Nicor maintained that from August 27, 2008, to October 23, 2008, when Staff filed its direct and rebuttal testimony, the Dow Jones Industrial Average fell by 25%. Over the same time period, Ms. Kight-Garlisch's use of a "new" and "unprecedented" CAPM approach reduced Staff's overall recommended ROE from 10.16% to 9.68%. Nicor witness Mr. Fetter cautioned the Commission against the "destabilizing effect" of Staff's sharply reduced ROE proposal, if adopted in a period of "extreme" market turmoil.

Nicor asserted that the Commission should reject Staff's alternative CAPM calculation, which employed the adjusted Value Line betas used by Nicor and a selection of published raw betas. According to Nicor, Staff provided no criteria for its selection of these published unadjusted betas. Also according to Nicor, Staff obtained and adjusted these raw published betas in response to Dr. Makholm's testimony that published betas are a more objective source of data that is preferable to Staff's estimated regression betas presented in Staff's direct case. Staff's approach produces an 11.39% CAPM result. In Nicor's view, while it is less inconsistent than Staff's ad hoc use of raw and adjusted betas to reach its recommended CAPM cost of equity, Staff's alternative CAPM approach is equally subjective and untested. Nicor Initial Brief at 56-57.

Nicor also argued that the Commission should disregard Ms. Kight-Garlisch's original CAPM proposal, which, Staff implies, should be adopted in the event the Commission rejects her other CAPM proposals. In her direct testimony, Ms. Kight-Garlisch calculated Nicor's CAPM cost of equity at 11.56% using an average of adjusted Value Line betas and her own "regression beta" estimates. Nicor stated that Staff employed a similar approach in its 2004 Rate Case, but the Commission selected the Company's CAPM methodology. *Id.*

Nicor agreed with Staff's contention that the Commission should reject CUB witness Thomas' recommendation to calculate Nicor's ROE using only the DCF method (excluding the CAPM approach). This Commission repeatedly has rejected the same recommendation from Mr. Thomas and nothing in Mr. Thomas' academic evidence or empirical analysis presented here favors elimination of the CAPM method from the Commission's accepted ROE methodology.

c. Risk Adjustment to Model Results

Nicor objected to Staff's proposal, which was an additional 25 basis point risk downward adjustment to its calculated ROE. Nicor acknowledged that the Commission adopted a similar, but smaller (23 basis point) risk adjustment to Nicor's ROE in the 2004 rate case. However, Nicor disagreed with the Commission's downward risk adjustment in the 2004 rate case. Dr. Makholm testified that Ms. Kight-Garlisch did not produce any evidence to demonstrate that the equity markets agree with her regarding the relative risk of Nicor vis-à-vis the comparable group of companies. Dr. Makholm testified that, while Ms. Kight-Garlisch may believe that her analysis of Nicor's relative credit risk is rational, equity and debt are very different financial securities. Also, the difference between the bond yield of AA and A rated bonds has no tie to the differences in equity risk of comparing a proxy group to a single firm. *Id.* at 59.

d. Effect of Proposed Riders

Nicor asserted that the billing mechanisms contained in its proposed new cost-recovery riders have no effect on ROE. According to Nicor, the record contains no empirical support for these "purely speculative" adjustments. Nicor contended that Staff conceded that it cannot quantify "the precise impact" that adopting any of the Riders might have on the Company's credit profile, if at all. Nicor also argued that the wide discrepancy between Staff's and CUB's recommendations for reducing the Company's ROE based upon the new riders (13 v. 58 basis points) supports the conclusion that these adjustments lack foundation. Nicor asserted that the sheer size of CUB's proposed downward adjustment in this proceeding, which would be nearly six times the Rider VBA adjustment adopted by the Commission in the 2007 Peoples Gas rate case, further undermines these proposals. *Id.*

2. Staff's Position

Staff witness Ms. Kight-Garlisch estimated the investor-required rate of return on common equity to be 9.68% for Nicor. She measured the investor-required rate of return on common equity with the discounted cash flow and capital asset pricing model analyses. She applied those models to a sample of utility companies with operating risk levels similar to that of Nicor. Her utility sample consists of the same companies used by Company witness Dr. Makholm with the exclusion of MGE Energy Corp. Ms. Kight-Garlisch removed MGE Energy Corp. from the utility sample because it lacked a growth rate estimate from Zacks Investment Research ("Zacks").

a. Discounted Cash Flow Model

Staff stated that DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, Staff argued it must correctly reflect the timing of the dividend payments that stock prices embody. The companies in Ms. Kight-Garlisch's utility sample pay dividends on a quarterly basis. Therefore, Ms. Kight-Garlisch applied a quarterly DCF model.

Ms. Kight-Garlisch employed a multi-stage, non-constant DCF model in her DCF analysis. She stated that a non-constant growth DCF model is a more elaborate model with additional unobservable growth rate variables that are likely subject to greater measurement error than the analyst growth rate estimates Staff uses in constant-growth DCF analyses. Staff contended that the cost of common equity estimate derived from a constant-growth DCF model is valid only if the near-term growth rate forecast for each company in the sample is expected to equal its average long-term dividend growth. In this case, Staff stated that the expected near-term growth level for the utility sample (6.64%) was greater than that expected for the overall economy, as measured by gross domestic product ("GDP") growth (approximately 5%).

Ms. Kight-Garlisch averred that, in theory, no company could sustain into infinity a growth rate any greater than that of the overall economy or it would eventually grow to become the entire economy. Since utilities in particular are generally below-average growth companies, the sustainability of an above average growth rate is particularly dubious. In Staff's view, given the large difference between the growth rates for the utility sample companies and the overall growth of the economy, the continuous sustainability of the Zacks growth rates for the utility Sample is highly unlikely. Therefore, Ms. Kight-Garlisch concluded that the measurement error associated with a constant-growth DCF analysis exceeds that associated with a non-constant growth DCF model, making the latter model preferable. Staff Initial Brief at 47-49.

Ms. Kight-Garlisch's non-constant growth DCF model incorporated three stages of dividend growth. The first, a near-term growth stage, is assumed to last five years. For this stage, Ms. Kight-Garlisch used Zacks growth rate estimates as of July 22, 2008. The second stage is a transitional growth period that spans from the beginning of the sixth year through the end of the tenth year. The growth rate employed in the transitional growth period equals the average of the Zacks growth rate and the "steady-state" stage growth rate. Finally, the third, or "steady-state," growth stage commences at the end of the tenth year and is assumed to last into perpetuity. For this stage, Ms. Kight-Garlisch used the implied 20-year forward U.S. Treasury rate in ten years, which reflects current expectations of the long-term overall economic growth during the steady-state growth stage of her non-constant DCF model. *Id.*

An expected stream of dividends for each company in the utility sample was then estimated by applying the growth rate estimates for those three stages to the July 22, 2008, dividend. The discount rate that equates the present value of this expected stream of cash flows to the company's July 22, 2008 stock price. This equals the market-required return on common equity. Based on this growth, stock price, and dividend data, Ms. Kight-Garlisch's DCF estimate of the cost of common equity was 9.25% for the utility sample. *Id.*

b. Capital Asset Pricing Model

Ms. Kight-Garlisch used a one-factor risk premium model, the CAPM, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which cannot be eliminated through portfolio diversification. The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Ms. Kight-Garlisch combined published betas from Value Line (adjusted) and the average beta estimate from Reuters, Scottrade, Yahoo!, and Zacks (raw). The average Value Line beta estimate was 0.87, while the average beta estimate from Reuters, Scottrade, Yahoo! and Zacks was 0.46. She noted that her inclusion of published raw betas should not be construed as Staff's agreement that raw betas are appropriate for CAPM analysis. Ms. Kight-Garlisch explained that since Nicor's witness Mr. Makholm espoused published betas, she included all published beta estimates that she obtained from well-known financial websites only to reduce the issues in this case. *Id.* at 49-51.

For the risk-free rate parameter, she considered the 1.51% yield on four-week U.S. Treasury bills and the 4.72% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of July 22, 2008. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.4% and 5.4%. Thus, Ms. Kight-Garlisch concluded that the U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. Finally, for the expected rate of return on the market parameter, Ms. Kight-Garlisch conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market equals 13.49%. Inputting those three parameters into the CAPM, Ms. Kight-Garlisch calculated a cost of common equity estimate of 10.60% for the utility sample. Based on her analysis, Ms. Kight-Garlisch estimated that the investor-required rate of return on common equity for Nicor equals 9.68%. *Id.* at 51.

According to Staff, the SV component of Dr. Makholm's sustainable growth rate estimates, which is intended to measure the expected growth from new common stock issuances, is biased upward, due to his assumption that all new common stock will be issued at the prevailing market price. Dr. Makholm stated that investors can expect growth through the sale of new stock, S, at a premium over book value, V, to estimate that premium, Dr. Makholm divided the year-end 2006 book value per share into the adjusted closing market price. That data produces an average market value to book value ratio for Dr. Makholm's sample of approximately 1.7 times. Staff argued, however, that Nicor has not provided any documentation to support the assumption that the new common stock was, let alone will be, issued at a 70% premium to book value. According to Staff, when asked to provide information relating to the price at which the companies in his sample issued new common stock, Dr. Makholm admitted that he had not collected such information. Staff maintained that the 1.7 times the average book value to market value ratio that was assumed for Dr. Makholm's sample, and the resulting sustainable growth rate estimates, are upwardly biased. Ms. Kight-Garlisch provided documents that, according to Staff, show that at least some of the companies' common stock issuances in Dr. Makholm's sample were, in fact, stock options that were exercised at prices that were well-below the prevailing market value of the common stock. To the degree that any new common stock is issued at less than a 70% premium over book value, Staff insisted, the SV component of the sustainable growth rate estimate is overstated. Staff Initial Brief at 60-62.

Dr. Makholm criticizes the use of GDP as the stage 3 growth rate in Staff's non-constant DCF analysis. However, according to Staff, Dr. Makholm incorrectly asserted that a company can sustain a growth rate greater than that of the overall economy. Staff stated that Dr. Makholm provided nothing to support his assertion. However, Staff provides a citation to a financial textbook that it believes refutes Dr. Makholm's assertion and another to support Staff's use of the GDP as the terminal growth rate. Staff disputed Dr. Makholm's argument that utilities are not below-average growth companies. According to Staff, the data Dr. Makholm relied upon suggests that, relative to the overall market, the utility companies composing his sample are below-average growth companies.

Dr. Makholm argued that Ms. Kight-Garlisch's use of GDP for the terminal growth rate is without Commission precedent. Staff responded that, in fact, the Commission has approved the use of the GDP as the terminal growth rate in several recent proceedings. Therefore, Staff maintains that Dr. Makholm's criticisms of the GDP as the terminal growth rate for use in the non-constant DCF should be rejected. *Id.* at 61-62

CUB witness Mr. Thomas argued that analyst growth rate forecasts should not be used exclusively. As support for his argument against analyst growth forecasts, he cited several studies and implied that those studies can be applied to utility growth rates. Staff argued, however, that those studies do not support his position. According to Staff, the studies he cites tend to report generalized findings and do not specifically suggest that growth rates for utilities are overstated relative to achieved growth. *Id.* at 63.

Staff maintained that a study by Chan, Karceski, and Lakonishok indicates that analyst growth rate estimates for utilities are not overstated. The authors of that study sorted by growth rate all domestic firms with available IBES long-term growth rate estimates, forming value-weighted portfolios in each quintile after each year, and found that the growth rates for portfolios of companies falling in the highest quintiles (*i.e.,* having the highest growth rates) tend to be overstated relative to the growth achieved over the five years post ranking.[9] Staff added that the study also indicates that the growth rates for portfolios of companies falling in the lowest quintile show no such tendency. That study further notes, Staff averred, that the bottom quintile of portfolios is predominantly comprised of firms in mature industries, with approximately 25% of those firms being utilities. In Staff's view, utility growth rates do not appear to be upwardly biased estimators of achieved growth five years ex post.

[9] A quintile is one-fifth of a given amount. Merriam-Webster.com.

Dr. Makholm argued that it is preferable to use published betas that are visible to investors. However, Staff is of the opinion that the validity of a beta estimation methodology is not a function of whether the resulting beta estimates are readily visible to the market. Rather, according to Staff, the validity of the methodology is a function of whether it is generally accepted. The methodology Staff used to calculate the regression beta for the utility sample in its direct testimony, which Staff has regularly used and the Commission has consistently approved, employs the same monthly frequency of stock price data as the widely-accepted Merrill Lynch methodology.

In Staff's view, the regression beta calculation is proper for use in the CAPM model. However, to reduce issues in this case, Staff updated its CAPM results using only published betas. Thus, the beta estimate used in Staff's updated CAPM is the average of the four published raw beta estimates (*i.e.,* Reuters, Scottrade, Yahoo!, Zacks) and one published adjusted beta estimate (*i.e.*, Value Line). This approach results in an average published beta of 0.67, a CAPM cost of common equity estimate of 10.60% for the utility sample, and an overall cost of common equity estimate of 9.68% for Nicor. Staff Initial Brief at 58-59.

Ms. Kight-Garlisch noted that the Commission has traditionally relied upon adjusted beta estimates. Therefore, she also presented an updated CAPM analysis in which she adjusted the published beta estimates from Reuters, Scottrade, Yahoo!, and Zacks before she combined them with the beta estimate for Value Line. The result is a CAPM cost of common equity estimate of 11.39% for the utility sample, and an overall cost of common equity estimate of 10.07% for Nicor. *Id.* at 60.

Should the Commission decide to adhere to its usual approach for estimating beta (*i.e.,* averaging Staff's regression beta with the Value Line beta), the average beta would be 0.78. Under this approach, the CAPM cost of common equity estimate equals 11.56% for the utility sample and an overall cost of common equity estimate of 10.16% for Nicor.

Mr. Thomas challenged the use of the CAPM in determining Nicor's cost of equity, claiming that a paper by Gregory L. Nagel *et al.* (the "Nagel paper") rejects the version of the CAPM traditionally used by the Commission. Staff maintained that Mr. Thomas is incorrect because the Nagel paper did not evaluate, and did not reject, the version of the CAPM that is traditionally used by the Commission. Staff stated that the Nagel paper does not apply to Staff's CAPM, because it does not evaluate a CAPM that utilizes adjusted betas. According to Staff, the Nagel paper found that a CAPM using raw betas was less accurate in predicting realized rates of return than a naïve model that assumes the same cost of equity.

c. Risk Adjustment to Model Results

To determine the suitability of this cost of equity estimate for Nicor, Ms. Kight-Garlisch assessed the risk level of her utility sample relative to that of Nicor. In her judgment, given the difference between the implied forward-looking credit ratings for Nicor, and the average credit rating of the utility sample, the sample's average cost of common equity needs to be adjusted to determine the final estimate of the Company's costs of common equity. Ms. Kight-Garlisch adjusted the utility sample cost of equity downward 25 basis points. The 25 basis point adjustment equals the spread between Baa1 and A2 30-year utility debt yields. Staff Initial Brief at 57-58.

Staff disputed Dr. Makholm's contention that average credit rating differences have no conceptual read-across to any possible equity risk difference and that Staff's adjustment has no credible basis from a standpoint of financial theory or practice. According to Staff, the risk/return tradeoff (*i.e.,* investors require higher returns to accept greater exposure to risk) is a fundamental principle of finance. That concept forms the basis of Staff's adjustment. Staff stated that, while Dr. Makholm is correct that credit ratings do not measure common equity risk, to conclude that there is no relationship between credit risk and equity risk is incorrect. Staff believes that while the relationship between credit ratings and equity risk is not perfect, credit ratings and equity risk are certainly related. Nobel Prize winners Modigliani & Miller conclude that equity costs are affected by debt leverage.

Staff maintained that credit ratings are also affected by debt leverage. As debt leverage rises, the cost of equity rises and credit ratings fall and vice versa. Thus, Staff maintained, there is an inverse relationship between credit ratings and equity costs. Staff stated that this is precisely the relationship Ms. Kight-Garlisch is modeling. According to Staff, while there is no way to directly measure that relationship, to ignore the risk differential between her utility sample's rating and Nicor's' rating, as Dr. Makholm espouses, would clearly be inappropriate. Staff is of the opinion that the approach she has adopted is consistent with the approach Staff has taken, and the Commission has accepted, under similar circumstances in previous proceedings.

d. Effect of Proposed Riders

Staff witness Kight-Garlisch did not incorporate the lower risk associated with the revenue decoupling mechanism (Rider VBA) that Nicor is proposing in this proceeding in her cost of equity recommendation. According to Staff, the gas decoupling rider Nicor proposes would effectively separate its fixed cost recovery from the amount of gas that it sells, which would result in actual utility revenues that more closely track its projected revenue requirement. This revenue stabilization, Staff asserted, would increase the probability that Nicor will earn its authorized rate of return and reduce cash flow volatility. Staff averred that Moody's states that rate designs that compensate gas utility for margin losses caused by conservation and weather-related variations in gas consumption stabilize the utility's credit metrics and credit ratings. In Staff's view, use of a gas decoupling mechanism would reduce the gas utility's risk. Staff maintained that a downward adjustment to the rate of return on common equity is appropriate to recognize the reduction in risk associated with the use of a decoupling mechanism. *Id.* at 64-65.

Staff stated that the uncollectible expense adjustment rider ("bad debt rider," or, "Rider UEA") that Nicor proposes would reduce the volatility in bad debt expense, which would result in actual utility costs that more closely track its projected revenue requirement. Staff stated this cost recovery provides the utility with greater assurance that the authorized rate of return will be earned. Rider UEA includes a provision for credits to customers, if the actual amount of uncollectible expense is less than 95% of the amount approved here. Staff asserted, however, that had Rider UEA been in effect the past ten years, Nicor would not have credited customers even once. According to Staff, in nine of the past 10 years Nicor would have increased customer bills because its uncollectible expense exceeded the amount approved in the prior rate case by more than 105%. Since Rider UEA would reduce the volatility in cash flow, Staff opined that it would reduce the risk of the gas utility. In Staff's view, a downward adjustment to the rate of return on common equity is appropriate to recognize the reduction in risk associated with the use of a bad debt rider. *Id.* at 65-66.

Nicor's proposed company use adjustment rider ("Rider CUA") would ensure that it will recover the price of company use gas, even if the price of gas deviates from what is used to develop base rates. Staff asserted that the Company's exposure to gas price volatility will therefore be significantly reduced. Staff stated that this price stabilization provides Nicor with greater assurance that the authorized rate of return will be earned. Staff believes that the use of Rider CUA would reduce Nicor's risk. According to Staff, a downward adjustment to the rate of return on common equity is appropriate to recognize the reduction in risk associated with Rider CUA. *Id.* at 66.

Staff maintained that Rider QIP's effect on Nicor's risk (and thus, its costs of capital) is a function of how it would operate. In comparison to rate base cost recovery, recovery of the capital costs of projects run through Rider QIP would be quicker. With all else equal, this reduction in regulatory lag reduces the risk of Rider QIP projects. In addition, Nicor proposed that the rider include a true-up. Staff believes a true-up increases the probability that Nicor will recover all of its QIP costs, including a return on the capitalized costs, relative to rate base costs. Staff averred that the increased certainty of more timely cost recovery would decrease the risk of Rider QIP projects. Thus, Staff asserted, a downward adjustment to the Company's costs of common equity would be appropriate for Rider QIP. *Id.* at 66-67.

Ms. Kight-Garlisch examined each rider individually to assess the appropriate risk reduction to Nicor for each rider. The table below summarizes Staff's recommended adjustment to the authorized ROE for each Rider:

VBA	.065%
UEA	.065%
CUA	none
QIP	none

Hence, Ms. Kight-Garlisch recommended that the return on common equity for Nicor should be reduced by the 13 basis point spread between its going forward credit rating of A2 and Aa3, if the Commission approves all four riders. *Id.* at 68-69.

3. CUB's Position

CUB argued that the ROE that investors require for their investment in Nicor is 9.455%. While investors may, at times, desire higher rates of return, CUB contends that Illinois law dictates that a utility is only entitled an opportunity to recover this necessary level of return through regulated rates as a prudently incurred cost. To determine this unobservable cost, CUB stated that financial analysts have developed tools, such as the DCF and CAPM, to estimate the cost of equity from observable market factors. The expert witnesses in this proceeding used various combinations of these models to develop their cost of equity estimates. In CUB witness Mr. Thomas' opinion, a properly constructed DCF analysis yields a cost of equity of 9.455%, which represents the return necessary to maintain Nicor's access to equity capital markets on reasonable terms. CUB Initial Brief at 15-17.

CUB stated the key difference between Mr. Thomas' recommendation of 9.455%, and those of Staff and Nicor is that, while Staff and Nicor rely on an average of the CAPM and the DCF, Mr. Thomas relies only on the DCF. In support of this method, Mr. Thomas argued that collected academic research and a detailed empirical analysis demonstrate that the CAPM is simply inappropriate for use in setting rates for regulated utilities. CUB asserted that the Commission has not previously reviewed such an analysis, and the results require a fresh look at the ROE calculation methodology the Commission has previously accepted for Nicor. *Id.* at 17-18.

a. Capital Asset Pricing Model

CUB stated that the CAPM is an analytical tool that has been used by the Commission in previous cases to estimate investors' required rate of return, or the cost of equity capital. However, CUB contended, current academic evidence indicates that the CAPM is not a very accurate model. Mr. Thomas presented an empirical analysis of the specific company at issue in this case, which he stated demonstrates that the CAPM, which the Commission has traditionally relied on, is upwardly biased and is unreliable for use in setting rates. *Id.* at 18.

CUB submitted that the CAPM model theorizes that the cost of capital is the rate of return on risk free assets plus the value of the market, or non-diversifiable risk, that investors assume by investing in a company. CUB added that the amount of market, or non-diversifiable, risk that investors are exposed to by their investment is measured by a parameter commonly referred to as beta. CUB averred that not only is the beta parameter a critical driver of CAPM results, but beta is also exceedingly difficult to estimate, so much so that its estimation has long been a topic of debate in the academic literature. In applying the CAPM to determine regulated utility ROEs, the Commission has previously accepted a methodology that requires an adjustment to raw, or unadjusted, beta parameters.

CUB noted that the Commission has traditionally adjusted beta using a method commonly referred to as the mean reversion adjustment. CUB explained that the beta parameter represents the degree to which the price of a stock moves with the overall market. A beta of 1.0 represents a stock that moves in complete unison with the overall market, and therefore has exactly the same risk as the overall market. If the beta is less than 1.0, then the stock is less volatile than the overall market, indicating that returns are more stable and presumably less risky. If the beta is greater than 1.0, then the stock is more volatile than the overall market, which indicates that the price changes more dramatically than prices in the overall market and, therefore, the stock is riskier than the market. According to CUB, the mean reversion adjustment assumes that raw betas, calculated from unadjusted market data, are not stable and must be adjusted based on the assumption that there is a long-term tendency for betas to move towards the market mean, 1.0. CUB Initial Brief at 18-19.

CUB argued that the mean reversion adjustment is not appropriate for utility companies because the risk (beta) of utility companies has not been shown to move towards the risk (beta) of other non-utility companies. Essentially, stated CUB, utility betas have not been shown to trend to a beta of 1.0. According to CUB, the financial literature demonstrates a contrary trend. CUB cited a study by Gambola and Kahl in 1990, which concluded that the mean reversion assumption is not appropriate for utility companies. CUB averred that even the seminal paper by Dr. Marshall Blume, which, CUB stated, is commonly cited as the primary source of evidence for the mean reversion adjustment, speculates that a one-size fits all reversion adjustment may not be appropriate for forward looking estimates. Dr. Blume suggested that such a mean reversion adjustment may actually introduce larger error into CAPM results than using unadjusted betas. The mean reversion adjustment proposed by Nicor, according to CUB, is a static mean reversion adjustment, meaning that it is a one size fits all adjustment. CUB stated that a static adjustment is the same for each company or group of companies, and does not change based on time or on any company-specific factors. *Id.* at 18-19.

Mr. Thomas conducted an empirical analysis of the companies in Dr. Makholm's sample of comparable natural gas and electric utilities. CUB argued that this analysis demonstrates that, for the companies in the sample group, the mean reversion adjustment that the Commission has traditionally relied upon introduces larger error into the CAPM, produces less accurate results, and therefore unnecessarily increases the cost of equity. CUB maintained that no party has disputed the results of this analysis. *Id.* at 19.

Mr. Thomas' analysis tests the validity of the CAPM under a variety of assumptions that focus on varying measures of both market return and the return on each individual security. CUB argued that the mean reversion adjustment produces less reliable results under a range of conceivable assumptions. This analysis supports the conclusion in the academic literature that the beta adjustment methodology is inappropriate for regulated utility companies. CUB further argued that this demonstrates that for the utilities in Dr. Makholm's sample of comparable utilities, the mean reversion adjustment produces beta estimates that are less accurate than raw, or unadjusted, betas. According to CUB, this demonstrates that the mean reversion adjustment actually increases the inaccuracy of the CAPM for the sample companies. CUB averred that the Commission's traditional assumption, that utility company betas tend to revert to the market beta, is inappropriate and it overstates the beta parameter. CUB opined that this assumption introduces forecast error into the CAPM calculation and, at a minimum, it should be eliminated.

While CUB maintained that the CAPM is not a reliable model and that any CAPM results relying on adjusted betas should be rejected, CUB stated that Staff's methodology of averaging adjusted and unadjusted betas is not an unreasonable approach. If the Commission rejects CUB's position and determines that the CAPM should be used to determine Nicor's ROE, CUB urged the Commission to make clear that significant questions exist about the beta adjustment methodology, and either reject its use in the CAPM or adopt Staff's methodology of averaging adjusted and unadjusted beta estimates. *Id.* at 20-22.

CUB maintained that the Nagel Paper compared a very simplified version of the CAPM to the version of the CAPM that is traditionally used by the Commission and five other well-known theoretical models. The Nagel paper rejects the version of the CAPM that is traditionally used by the Commission because it has a higher forecast error than that of the simplified version. CUB alleged that, due to this forecast error, the Commission should reexamine the overall usefulness of the CAPM in rate-setting proceedings. The Commission has previously reviewed the Nagel paper, but CUB is of the opinion that the Commission has misinterpreted the paper's implications. For example, CUB argued, the Commission incorrectly concluded in its Final Order in Docket 07-0507 that this research actually supports its longstanding practice of relying on adjusted betas in the CAPM, and the CAPM model itself, to determine the ROE. The Commission concluded that the Nagel paper supports the conclusion that adjusted betas are preferable to unadjusted betas.

However, CUB maintained, for the companies in Dr. Makholm's sample of comparable utilities, the beta adjustment methodology actually results in less accurate beta estimates, which cannot be relied upon by the Commission. When this evidence is viewed in concert with the findings of the Nagel Paper, CUB contended that the Commission cannot rely upon the CAPM model as a determinant of Nicor's ROE. *Id.* at 22-23.

b. Discounted Cash Flow Model

CUB argued that the DCF model estimates the cost of equity capital by assuming that investors who purchase stock are paying a price that reflects the present value of the cash flows they expect to receive from the stock in the future. Mr. Thomas testified that the DCF model uses current stock price and expected cash flows from dividends and earnings growth to estimate the return that investors expect to receive. Investors' expectations of growth and cash flows, stated Mr. Thomas, are driven largely by historical experience, because analysts are frequently overly-optimistic.

Mr. Thomas based his return on equity recommendation on the DCF model, thereby avoiding dependence on what he views as the unreliable CAPM model used by other parties. In doing so, Mr. Thomas proposed to correct what he views as two errors in Dr. Makholm's analysis. Mr. Thomas averred that Dr. Makholm inappropriately included adjustments for selling and issuance expense in his results, a proposal which, he argues, is inconsistent with prior Commission practice. Also, Dr. Makholm has presented no evidence that could cause the Commission to change its practice and include these adjustments. Also, Dr. Makholm's sustainable growth rates, which are used in his analysis, are upwardly biased and inappropriate. CUB concluded that the result of removing these adjustments demonstrates that Nicor is only entitled to a

9.455% cost of common equity, which it stated will provide investors with a fair return on their investment in Nicor.

CUB explained that selling and issuance expense refers to the costs that Nicor would incur when it issues new common equity. CUB maintained that the Commission has traditionally disallowed adjustments to the ROE for selling and issuance expense when a company is unable to show that such adjustments have not previously been approved in rates. CUB cites the Commission's Final Order in Nicor's last general rate case, Docket 04-0779 (Order at 94). CUB Initial Brief at 26-27.

In this case, CUB argued, Nicor has not met its burden to demonstrate that the amounts being requested have actually been incurred. In addition, CUB averred that Nicor failed to demonstrate that its proposed Nicor-specific amounts were actually incurred for the sole benefit of Nicor, and not any for the benefit of affiliated interests. CUB also stated that Nicor goes even further by trying to include estimated selling and issuance expense costs that Nicor never incurred. CUB asserts this is inappropriate and should, therefore, be rejected.

CUB contended that the growth rate in the DCF model represents the sustainable growth that investors expect from their investments in a company. The sustainable growth rate is a critical component of the DCF model. It represents the amount of growth that investors expect to occur on their investment that is sustainable over the long-term. CUB argued that setting the growth rate component of the DCF model at an unreasonably high level would result in an estimate of the cost of equity that is also unreasonably high, all other things being equal. CUB also averred that company growth is traditionally measured in several ways, growth in earnings, growth in dividend, and "fundamental growth" or the growth in retained earnings. CUB opined that Dr. Makholm's proposed 5.82% sustainable growth rate is based upon three different measures of growth: analysts' estimates from both Value Line and Zack's and a fundamental growth rate calculation, which he performed.

CUB argued that historically analysts have set their sustainable growth rate assumptions at unreasonably and unsustainably high levels. Financial researchers have documented this bias extensively, as summarized in Mr. Thomas' testimony. According to CUB, the literature is clear about the bias inherent in analysts' growth forecasts.

CUB acknowledged that the Commission has traditionally accepted such forecasts as the sole determinant of growth. It suggested, though, that if the Commission were to rely on analysts' forecasts, it must not use them as the sole determinant. CUB argued that the Commission can balance analysts' views with measures of historic growth. CUB stated that, while such an approach is sub- optimal, it is preferable to relying solely on analysts' forecasts.

CUB stated that fundamental growth, which Dr. Makholm refers to as retention growth or sustainable growth, divides growth into two distinct components. These are internal growth, which is the growth that occurs through the capital retained within the business, and external growth, which is the growth from injecting capital into the business through external financing sources. According to CUB, Dr. Makholm tries to increase the results of his fundamental growth analysis by incorporating an adjustment for the issuance and sale of new common stock, which is sometimes referred to as external growth. CUB contended that such an adjustment is simply not appropriate for regulated public utilities like Nicor. CUB stated that, for regulated utilities, absent concrete plans to issue new common stock in the entity, it is inappropriate to incorporate measures of external financing. CUB argued this is completely consistent with the Commission's practice of granting regulated utilities a return on only their prudent and reasonably incurred investments during the test year (along with any approved pro forma adjustments). CUB concluded that in addition, Dr. Makholm has not shown that access to additional capital will somehow be impaired by looking only at internal growth. It argued, additionally, if the Commission approves Nicor's Proposed Rider QIP proposal, the riskiness of some future capital investments declines substantially, so Nicor will not be raising capital on the same terms upon which it has in the past.

c. Effect of Proposed Riders

CUB opposed Nicor's proposed new riders in this proceeding. It argued that these riders have clear financial benefits to the Company and its equity shareholders that need to be recognized in the rate setting process. CUB maintained that Rider 26 - Uncollectible Expense Adjustment ("Rider UEA"), Rider 27 - Company Use Adjustment ("Rider CUA"), Rider 28 - Volume Balancing Adjustment ("Rider VBA"), and Rider 30 - Qualifying Infrastructure Plant ("Rider QIP") will all have favorable impacts on Nicor's future revenues and income levels while reducing existing levels of operating risk arising from regulatory lag.

CUB stated that Rider UEA and Rider CUA will improve the Company's opportunity to earn a return by limiting exposure to the fluctuating cost of natural gas. CUB opined that Rider VBA will protect Nicor from deviations in sales due to fluctuations in normal weather conditions and reduced customer demand. CUB added that Rider QIP limits regulatory lag and allows Nicor to earn returns on certain new infrastructure between general rate cases. In CUB's view, Riders UEA, CUA and VBA will significantly reduce the Company's cash flow variability, and reduce the overall operating risk that arises from regulatory lag, *i.e.*, the timing between changes in a Company's operating income and the inclusion of those items in rate base or revenue requirement.

According to CUB, the benefits of Riders UEA, CUA, and VBA accrue directly to the Company's common equity shareholders. CUB argued that equity holders are exposed to more cash flow risk than debt holders because public utility debt holders are paid first out of earnings. However, the remaining earnings accrue to shareholders through growth from retained earnings and cash flows from dividends. CUB stated that, because these Riders provide revenue stability, the value of this stability accrues directly to equity shareholders. CUB Initial Brief at 30-31.

CUB averred that the actual value of these riders to Nicor's investors is much greater than the 10 basis points approved by the Commission in the Peoples Gas Rate

Case Order. It argued that the impact that Riders CUA, UEA, and VBA would have had on Nicor's return would have been to increase Nicor's total ROE by between 96 and 391 basis points, with an average impact of 242 basis points. In order to recognize the significant value of these Riders, CUB averred that the Commission should use Mr. Thomas' proposal to estimate the impact that these riders will have on future net income at slightly less than 25% of the impact that they would have had, if they were in place during the previous decade.

CUB asserted that this results in a total reduction in ROE of 58 basis points. It stated that the Commission should increase its previously-approved adjustment to 25 basis points for Rider VBA. If Rider UEA had been in effect during the 1998 to 2007 time period, CUB maintained, it would have had a similar, but somewhat larger, effect than Rider VBA, on average. CUB urged the Commission to approve an equivalent adjustment for each Rider. CUB recommends 25 basis points for each Rider.

CUB contended that Rider CUA would have had a smaller impact on the Company's revenues, however, it would still have provided significant certainty to shareholders. CUB recommended that the Commission approve an adjustment for Rider CUA that is proportionate to its impact on the Company's revenues, which is, in this case, 8 basis points (($2.2 million / $7.2 million) times 25 basis points = 7.6 basis points).

If the Commission rejects Nicor's proposed Rider VBA and instead approves an increase to the customer charge, CUB stated that it should adopt a 25 basis point adjustment to the cost of equity proposed by CUB, as Nicor will face a risk that is significantly reduced when investing capital to replace existing cast iron and copper mains because of the cost recovery guarantee that is implicit in Rider QIP. According to CUB, this risk reduction is significant because it protects investors from the possibility that they will fail to recover their investment. If Rider QIP is approved, Nicor should receive a cost of capital on any investment made under Rider QIP that is equivalent to its embedded cost of long-term debt, for which, Nicor has proposed 6.80%. According to CUB, this return will allow Nicor access to the capital it needs to finance projects under Rider QIP, while recognizing the dramatically reduced risk of recovery for projects financed through the Rider. CUB opined that this adjustment is conservative and the Commission may find that other, additional measures are necessary.

4. The AG's Position

The AG agreed with the analysis and conclusions of CUB witness Mr. Thomas, and supported his recommendation that the Commission grant Nicor a 9.455% rate of return on common equity.

5. Analysis and Conclusions

Before we turn to the details of the parties' return on equity estimates, it is apparent that what some parties seek is for the Commission to abandon or deviate from certain past practices in light of new evidence or circumstances. We must balance two competing interests in evaluating such proposals. While we do not wish to ignore past practices, which appear to have served utilities and ratepayers for many years, neither do we wish to engage in cost of equity estimation in a manner that might be viewed as random or arbitrary. We recognize that we must also consider the possibility that new evidence or research has been developed that should cause the Commission to deviate from past practices. While the Commission recognizes that, due to the competing interests present, it is not possible to satisfy all parties, we will undertake to reach well-reasoned conclusions that are based on the record, and consistent with previous Commission decisions, to the extent possible.

a. Capital Asset Pricing Model

First, we consider Mr. Thomas' recommendation that the CAPM should not be used as a primary tool to estimate cost of equity. According to Mr. Thomas, it should only be used to check the reasonableness of the DCF model. He contends that CAPM has such bias in its calculations that it is unreasonable to rely on it to estimate cost of equity. The Commission notes it has considered this argument previously in several recent rate cases. As was the case in those recent rate cases, Mr. Thomas' recommendation relies heavily on the Nagel Paper, which is discussed in the parties' testimony and briefs.

Mr. Thomas argues that the version of CAPM used by the Commission was rejected in the Nagel Paper as having a higher forecast error than the more simplified version. The Commission, however, finds the rebuttal testimony of Staff (Staff Exhibit 19.0 at 16-19) regarding CAPM and beta to be very convincing. Thus, the Commission, which has previously rejected CUB's arguments regarding CAPM and beta, does not believe that the record in this proceeding supports a finding that the Nagel paper undermines the usefulness of CAPM in setting market required returns on equity in utility cases.

Among the analyses presented by Staff, allegedly in response to Nicor's preference for the use of published betas, was a CAPM analysis using only published betas, which included "raw" or "unadjusted" betas. In this analysis, the beta estimate used was the average of the four published raw beta estimates (Reuters, Scottrade, Yahoo!, and Zacks) and one published adjusted beta estimate (Value Line). This approach resulted in an average published beta of 0.67. Apparently, because the Commission has traditionally relied upon adjusted beta estimates, Staff also presented a CAPM analysis, in which it adjusted the raw or unadjusted published beta estimates from Reuters, Scottrade, Yahoo!, and Zacks before combining them with the beta adjusted estimate for Value Line.

While CUB maintains that the CAPM is not a reliable model and that any CAPM results relying on adjusted betas should be rejected, CUB stated that Staff's methodology of averaging adjusted and unadjusted betas is not an unreasonable approach. If the Commission rejects CUB's position, and determines that the CAPM should be used to determine Nicor's ROE, CUB urges the Commission to make clear that significant questions exist about the beta adjustment methodology and either reject its use in the CAPM, or adopt Staff's methodology of averaging adjusted and unadjusted beta estimates.

The recommendation made by CUB and suggested by Staff that unadjusted betas should be used in the CAPM are rejected. The record does not support the proposition that unadjusted betas are superior to adjusted betas. To the contrary, the evidence shows that betas, including betas of utilities, do follow the revision to the mean proposition and that the use of unadjusted betas would tend to produce biased results. Additionally, the Commission does not find Nicor's objections to the adjusted regression betas contained in Staff's direct testimony to be persuasive. While that the DCF model requires the use of an observable input, market price, in the estimate of the cost of common equity, there is no such requirement for the beta input in the CAPM. Nicor identified no actual flaw in the calculations underlying Staff's adjusted regression betas and the Commission finds that they constitute a reasonable proxy for systematic risk in the CAPM.

For purposes of establishing Nicor's ROE in this proceeding, the Commission finds that two of Staff's CAPM analyses are reasonable and deserve consideration. The analysis in Staff's direct testimony utilizing Value Line and regression betas, which produced an ROE estimate of 11.56%, and the analysis which relied upon "all" adjusted published betas, which produced an ROE estimate of 11.39%, are found to be reasonable. Additionally, the Commission finds that the CAPM analysis presented by Nicor, which produced an ROE estimate of 11.93%, is also reasonable and should be considered when estimating the cost of common equity.

b. Discounted Cash Flow Model

We next consider the various issues relating to the DCF model and the inputs thereto. Staff relied on a multi-stage, non-constant growth quarterly DCF model, while Nicor and CUB utilized constant growth quarterly DCF models. It appears that the primary disagreement amongst the parties regards the appropriate growth rates to be used in the DCF model.

Nicor's primary objection to Staff's DCF analysis is Staff's use of gross domestic product ("GDP") as the terminal growth rate. Staff suggests using a multi-stage, non-constant growth, quarterly DCF model in this proceeding. Staff believes that analyst growth rates are so high that they will not be sustainable in the long run for use in a constant growth model, and therefore, they produce too high of a return on equity results. The Commission notes that it has traditionally relied on a constant growth DCF model with analysts' estimates of EPS growth in developing the cost of common equity for utilities in rate cases; however, in some recent proceedings, including, in Docket 07-0585, the Commission's authorized return on equity has been based on a non-constant version of the DCF model. Due to concerns about the sustainability of analysts' growth rates, the Commission finds that Staff's arguments that using GDP as a proxy for the terminal growth rate in a non-constant DCF analysis has merit. A DCF analysis that effectively caps the terminal growth rate for companies in the sample at the GDP growth rate, which is a reasonable proxy for growth in the U.S. economy, will provide useful information and produce a reasonable estimate of the cost of common equity of the firms in the sample. Thus, for purposes of establishing Nicor's cost of equity in this proceeding, we are of the opinion that it is reasonable to consider Staff's non-constant DCF analysis.

CUB opposes the use of analysts' forecasts of growth, which is relied upon by both Nicor and Staff. In several recent rate cases, CUB has taken the same position. It has provided essentially no new information or argument in this proceeding. Finally, the Commission notes that in this case, CUB's recommendation is based upon a modification of Nicor's DCF analyses, which incorporates analysts' growth rates. The Commission rejects CUB's assertion that analyst growth rates are inherently flawed or inherently overstate expected growth.

In addition to analyst growth rates, Nicor's witness used what are known as sustainable growth rates. Both Staff and CUB object to use of sustainable growth rates. Staff argues that the sustainable growth rates are biased upward due to the unsupported assumption that all new common stock will be issued at the prevailing market price. CUB complained that sustainable growth rates are upwardly biased because, in addition to attempting to capture internal growth, they incorporate an adjustment for the issuance and sale of new common stock, which, CUB stated, is sometimes referred to as external growth. In response, Nicor asserted that the actual effect of the "S*V" component on Nicor's DCF calculation is minimal.

As the Commission understands it, the only difference between Nicor's DCF cost of equity estimate, 9.83%, and CUB's DCF cost of equity estimate, 9.455%, is that CUB's calculation excludes the external growth component (S*V), which Nicor included. While Nicor maintains that the inclusion of an external growth component is appropriate, it concedes that the impact is minimal. The Nicor DCF analysis, as well as the CUB analysis, combines analysts' growth rates with the sustainable growth approach. Generally, the Commission does not look favorably on the sustainable growth approach; however, in this instance, the Commission finds it is not unreasonable to combine the sustainable growth rates with published growth rates to estimate the cost of common equity. The Commission finds that the criticisms of Nicor's external growth component of sustainable growth to be convincing and that Nicor's DCF results will not be considered. Thus, we conclude that CUB's DCF cost of equity estimate, 9.455%, should be considered in estimating Nicor's cost of common equity. As a result of the unusual combination of analyses and arguments presented by the parties, we will give consideration to Staff's non-constant DCF analysis, as well as the constant DCF analyses presented by CUB, which is essentially the Nicor analysis with one modification.

c. Risk Adjustment to Model Results

Staff argues that Nicor is less risky than the companies that make up the sample, on which its cost of equity analyses were performed and, therefore, recommends that the cost of equity modeling results should be reduced by 25 basis points when establishing Nicor's authorized return on common equity. Nicor disagrees with this proposal, but acknowledges that the Commission adopted a similar adjustment in its last rate case. We conclude that it is necessary and appropriate to evaluate whether an adjustment to the cost of common equity model results is necessary, given possible differences in risk between Nicor and the companies that make up the sample. Such an evaluation was performed in Nicor's last rate case and such evaluations are a normal part of the Commission's analyses. Having reviewed the record, we conclude that Staff's analysis is reasonable and convincing. That analysis demonstrates that Nicor's overall risk is less than that of the firms that comprise the sample. In the Commission's view, the conclusion on this issue in Docket 04-0779 was correct at the time. The situation in this proceeding is essentially the same, and the same conclusion holds here. Thus, the Commission concludes that, in establishing an authorized return on common equity for Nicor, the results of analyses applied to the sample must be reduced by 25 basis points.

d. Effect of Riders on Cost of Common Equity

The table below summarizes Staff's recommended adjustment to the authorized ROE for each of Nicor's proposed Riders:

VBA	.065%
UEA	.065%
CUA	none
QIP	none

CUB argues that approval of Rider VBA or Rider UEA would each reduce Nicor's cost of common equity by 25 basis points. CUB contends that Rider CUA would reduce Nicor's cost of common equity by 8 basis points. If Rider QIP is approved, CUB argues that Nicor should receive a cost of capital on any investment made under Rider QIP that is equivalent to its embedded cost of long-term debt, for which the Company has proposed 6.80%. According to CUB, this return will allow Nicor access to the capital it needs to finance projects under Rider QIP, while recognizing the reduced risk of recovery for projects financed through the rider. Nicor opposes any adjustment to its authorized return on common equity on the basis of reduced risk associated with approval of the riders in question.

For the reasons explained later in this Order, the Commission will not be adopting Rider VBA and instead will adopt Nicor's alternative 80% SFV rate design for Rate 1. The Commission, however, believes that adopting this rate design will clearly reduce Nicor's risk for many of the reasons identified by Staff with regard to VBA. As the record of this proceeding clearly demonstrates, quantifying the impact of the reduced risk is a difficult undertaking. Nevertheless, the Commission believes that CUB has overstated the impact of revenue stabilization on Nicor's operations. Instead, the Commission believes that, of the proposals in the record, Staff's quantification is the most reasonable. Thus, in determining Nicor's authorized return on common equity in this proceeding, we conclude that it necessary and appropriate to deduct 6.5 basis points to reflect the reduction in Nicor's risk resulting from the approval of Nicor's alternative 80% SFV rate design for Rate 1.

e. Authorized Return on Common Equity

Based upon all of the foregoing discussion and conclusions, the Commission finds that Nicor's cost of common equity is 10.11%. The table below demonstrates the derivation of the authorized return on common equity for Nicor.

Party	DCF	CAPM
Staff	9.25%	11.56%
Staff	-	11.39%
Nicor Gas	-	11.93%
CUB	9.455%	-
Average	9.35%	11.63%
Midpoint	10.49%	
Relative Risk Adjustment	0.25%	
Risk Reduction for Rider Adoption	0.065%	
Authorized ROE	10.17%	

f. Authorized Rate of Return on Rate Base

Taking into consideration the Commission's conclusions regarding capital structure, cost of short-term debt, cost of long-term debt, cost of preferred stock, and cost of common equity, the Commission finds that Nicor should be authorized to earn a 7.58% rate of return on original cost rate base for its natural gas operations. The table below shows the development of that authorized rate of return:

Approved Rate of Return on Rate Base

Source of Capital	Amount	Proportion	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%	10.17%	4.72%
Total	$ 1,404,040,765	100.00%		7.58%

VII. COST OF SERVICE AND ALLOCATION ISSUES

A. OVERVIEW

In Nicor's 2004 Rate Case, the residential customer class was assigned 95% of its cost of service. In this proceeding, in an effort to gradually move the residential class closer to its actual costs of service, Nicor proposes to assign the residential customer class 97.5% of its costs of service. Nicor Ex. 14.0 at 10. Nicor asserted that, when it developed its allocation proposal, it considered the principle of gradualism, the impact of the proposed increase on ratepayers, and the volatility of natural gas prices. No party has a contested issue with the Company's Embedded Cost of Service Study (Nicor's "ECOSS"). This Commission approved Nicor's ECOSS using the Average and Peak ("A&P") method, together with its Modified Distribution Main ("MDM") Study, in its last rate case. Here, Nicor proposes to use the A&P method within its ECOSS, in conjunction with its MDM Study. Nicor Initial Brief at 60.

Staff strongly supports using the A&P allocator. Staff pointed out that it was used in Nicor's last two rate cases. Also, it has been exclusively used for all other gas companies in Illinois for a number of years. Staff asserted that the A&P method is a hybrid methodology that employs two allocation methodologies for system costs. One allocator is based upon the class shares of average demand or usage levels. The second allocator represents the class contributions to system peak demands. Staff asserted that this Commission's approach has been to base the shares allocated on a utility system's load factor. The percentage of load representing average demand has been allocated according to average demands. The excess over the average was allocated in accordance with peak demands. Staff Initial Brief at 71.

Staff averred that the A&P method recognizes that two key factors drive investment in transmission and distribution plant. One is the need to meet peak demands, not just for individual classes, but, for the system as a whole. This, Staff asserted, is why coincident peak demands are used as one component of the allocator. Also, the allocator recognizes the role of year-round demands in shaping transmission and distribution investments through the average demand component. The investment associated with a distribution system could not be justified solely by demands on a peak day. Rather, Staff asserted, it is dictated by year-round demands by all ratepayers. Staff stated that the system load factor provides a reasonable dividing point because it measures the relationship between average usage and peak demand on an annual basis. *Id.* at 72.

B. **UNCONTESTED ISSUES**

1. The Allocation Factor Based on Services Investment by Customer Class

Nicor agreed to Staff's proposal that it shall prepare, in its next rate filing, an allocator within its ECOSS for gas service lines that reflects the amount of investment in services by customer class. Nicor Ex. 48.0 at 4. This requirement is reasonable and it is hereby approved.

2. The Allocation of Storage Losses

The IIEC identified certain corrections to Nicor's ECOSS wherein certain storage losses were assigned to transportation customers. IIEC Ex. 2.01 at 8-13. In its surrebuttal testimony, Nicor removed any allocation of storage losses to transportation customers from its ECOSS. Nicor Ex. 49.0 at 2.

C. CONTESTED ISSUES

1. Main Size Allocation

The IIEC proposed to remove $8.3 million in costs, based upon main size allocation factors, from commercial customers and reallocate these costs to residential customers.

a. Nicor's Position

Nicor asserted that its ECOSS reproduces the same cost classification and allocation methodology that was authorized by this Commission in its last rate case. Nicor additionally employed an MDM Study using test year forecasted numbers of customers, peak day demand and delivery volumes by rate class. Nicor's MDM study examines peak-day demand. In so doing, this study determines the proportion of peak-day flows by main size and rate class. It uses these proportions to allocate distribution main costs to its various classes. Nicor Ex. 14.0 at 7. The ECOSS uses the resulting cost allocation to allocate the peak-day demand-related portion of distribution main costs, which is, approximately 77%, to customer classes. The remaining 23% of these costs were allocated exactly the same way they were in Nicor's last rate case, based upon the annual volumes that are used by each rate class. Nicor Ex. 48.0 at 4-5.

Nicor contested the propriety of the IIEC's proposal to reallocate the volume-related costs in its ECOSS based upon the main size allocation factors in Nicor's MDM Study. It asserted that this proposal assumes that annual volume flows by main size and rate class are in the same proportion as peak-day volume flows by main size and rate class. Nicor also averred that this proposal is untested. However, to accommodate the IIEC's concern, Nicor has offered to review the IIEC's proposal and present its conclusions in testimony in its next general rate case. Nicor Initial Brief at 62-63.

Nicor's witness Mr. Mudra testified that Nicor prepared its MDM Study based upon a detailed analysis of peak-day gas flow by customer and by main size. However, Nicor did not analyze annual volume flows by customer and main size. The MDM study was not intended for that purpose; the IIEC nevertheless attempts to use the MDM Study for that purpose. Nicor's witness Mr. Heintz further testified that the MDM Study does not contain a direct measure of the distribution of annual volumes by size of pipe for each class. Nicor Ex. 49.0 at 4.

It asserted that this Commission should not assume that the peak-day percentage allocation factors used in the MDM Study would produce the same result as annual volume percentage factors. Also, given the fact that residential customers have relatively a low load in comparison to industrial customers, it is reasonable to assume that an allocation based upon peak-day volumes from the MDM Study may be different than an allocation based upon annual consumption. Nicor Ex. 48.0 at 5-6; Nicor Initial Brief at 62-63.

Additionally, the practical effect of the IIEC's proposal is to further increase residential rates and decrease commercial and industrial rates. Nicor asserted that the accuracy of this proposal should be tested before over eight million dollars is shifted to the residential rate class. Nicor Reply Brief at 57.

b. The IIEC's Position

The IIEC averred that, for purposes of cost allocation, Nicor's use of what is known as Average Demand disproportionately assigns more costs to the high-volume, high load factor classes, Rates 76 and 77. Use of the Average and Peak method, which allocates the cost of mains partially on the basis of average demands on volumes, shifts costs to Rates 76 and 77. On the other hand, use of the Coincident Peak method would have allocated these costs exclusively based upon peak demands.[10] The IIEC argued that these costs have been unfairly included in Rates 76 and Rate 77. Instead, it maintained, residential Rate 1 customers should bear the burden of these costs. IIEC Initial Brief at 5-7.

The IIEC's witness Dr. Rosenberg testified that Nicor's witness Mr. Heintz had, quite properly, used Nicor's MDM Study to allocate the demand portion of distribution mains. However, in Dr. Rosenberg's opinion, Mr. Heintz improperly ignored the MDM Study when he allocated the portion of mains that is deemed to be volume-related. IIEC Ex. 1.0 at 6.

He testified that the MDM Study recognizes that Nicor's system of mains is configured in such a way that not all customers in a class use all sizes of mains. As an example, the MDM Study showed that only a single Rate 77 customer used two inch mains. This customer represented 3.374% of the total peak day usage of Rate 77. Consequently, when allocating the two-inch mains, Mr. Heintz modified the peak demand of Rate 77 to use only 3.374% of that classes' peak demand. Also, the MDM Study showed that 81.35% of the Rate 1 class' peak day demand was delivered through two-inch mains, and that class demand was modified by 81.35% when allocating two-inch mains. By making these distinctions for each size of main, Dr. Rosenberg continued, Mr. Heintz was able to more accurately allocate the demand-related portion of Nicor's distribution mains. IIEC Ex. 1.0 at 4-5.

Dr. Rosenberg opined that that same principle also holds true for the volume-related portion of the mains. He averred that if all customers on Rate 77, except for one, do not use two-inch mains on the peak day, then, all Rate 77 customers, but one, make no use of two-inch mains on any other day. Dr. Rosenberg opined that just as the accuracy of the allocation of the demand-related portion of mains is improved by recognizing the MDM Study, the accuracy of the volume-related portion of mains can be improved by recognizing the physical fact that not all diameters of mains are used in serving some customers. *Id.* at 6-7.

In Dr. Rosenberg's opinion, the reason that all classes are not served to the same extent by different sizes of mains is because the largest-volume customers cannot be served by mains with smaller diameters. This is true, he surmised, because small mains do not have sufficient capacity to serve the largest-volume customers. The MDM Study captures and quantifies this fact. *Id.* at 7.

[10] The IIEC accepted use of the A&P main classification only in the context of Nicor's ECOSS, and only for the purpose of this case. IIEC Initial Brief at 2.

The IIEC asserted that the MDM Study determines the peak day flows for each size of distribution main in service and, also, the percentage of those peak day flows that are attributed to each customer class. By identifying the portions of each diameter of mains that are used to provide service to specific customer classes, the MDM Study accurately assigns main-related costs to the appropriate customer classes. IIEC Initial Brief at 6-7.

Dr. Rosenberg extended Nicor's original MDM Study to the volume-related portion of Nicor's distribution mains. The IIEC maintained that he did not merely apply Nicor's MDM Study results to volume-related costs. Instead, he extrapolated the MDM peak day flows to the average day as well. The IIEC concluded that Dr. Rosenberg used the relationship between average day demand and peak day demand for each class (the class load factor) to impute the average demand for each class on each size of main. *Id.* at 7-8.

The IIEC averred that there is relatively little that Dr. Rosenberg needed to assume when making his calculations. For very large mains, those that all customers use, the ratio of average demand to peak demand is known precisely for each class, because that ratio is the same for the whole system. Additionally, for very small mains, there is little need for approximation. *Id.* at 9.

c. Staff's Position

Staff maintained that the IIEC's proposal should be rejected. According to Staff, Dr. Rosenberg argues that Nicor erred when it allocated the average component of a transmission and distribution main costs to all customer classes.[11] Staff contended that Dr. Rosenberg considers this to be unfair to large nonresidential customers who do not make use of Nicor's smaller mains. Staff asserted that the IIEC's argument is fatally flawed because it does not take into account the purpose of the average component of the A&P in the allocation of transmission and distribution costs. Nicor has year-round demands that are imposed by all of its customers, which justifies the investment in a transmission and distribution system. This system consists of both large and small mains. Staff concluded that it would be unreasonable to assume that Nicor's investors justify a transmission and distribution system in two stages, by deciding whether demands by all customers are sufficient to justify the large transmission and distribution mains, and then, deciding whether the demands of smaller customers are sufficient for the construction of smaller mains. Staff Initial Brief at 74-75.

Staff pointed out that residential customers pay a significant share of the cost of larger-sized mains. For example, residential customers alone account for more than 52% of peak demand and 47% of throughput on Nicor's system. Staff concluded that residential customers, therefore, assume responsibility for a major share of the costs for all transmission and distribution mains on Nicor's system. Thus, according to Staff, the economic justification to build a transmission and distribution system is appropriately reflected in an average allocator for all customers that applies to all transmission and distribution mains. *Id.* at 75.

[11] In its Initial Brief, Staff refers to transmission and distribution costs as "T&D." *See,* Staff Initial Brief at 74, Staff Ex. 7.0 at 25.

d. Analysis and Conclusions

We decline to perform the reallocation that the IIEC proffers. What the IIEC proposes is untested. Therefore, it is really not known whether what the IIEC proposes would be based upon accurate and complete information. Moreover, the MDM Study does not contain a direct measure of the distribution of annual volumes by size of pipe for each class. It is possible that, as Nicor argues, an allocation based upon peak-day volumes from the MDM Study would be different than an allocation based upon annual consumption. We also note that even the IIEC acknowledges that Dr. Rosenberg made assumptions when making his calculations. We additionally note that Staff's testimony is indicia that Nicor's proposal may not be as disproportionate as the IIEC makes it out to be.

As Nicor has noted, the reallocation proposed is a large one, which should be undertaken carefully, when the evidence substantiates that it will be based on accurate and complete information. The better approach is the one taken by Nicor, which is, to explore this issue in-depth in testimony which, Nicor shall file in its next rate case.

2. Allocation of Storage Costs to Unbundled Rate Classes

The IIEC proposed that the storage costs for Nicor's Transportation customers, which are Rates 74, 75, 76 and 77, should be based upon the revenues Nicor receives from those customers. Pursuant to this proposal, currently, $11,000 would be reallocated amongst these customer classes.

a. The IIEC's Position

The IIEC contended that Nicor's ECOSS does not accurately allocate Nicor's storage-related costs among Nicor's Transportation customers. It argued that the responsibility for these storage costs should be assigned to Transportation customers in a manner that is equal to the revenue recovered from those customers through a cost-based storage charge, which is, the SBS charge. By definition, it asserted, a properly-designed SBS charge is cost-based. It concluded that the test year revenue that is presumed to be derived from the SBS charge must be equal to the responsibility for the costs that is allocated to Nicor's Transportation customers. IIEC Initial Brief at 10.

The IIEC acknowledged that there is little difference between it and Nicor on this issue. However, Nicor's total revenue requirement, and the amount of storage that is allotted to Transportation customers, as well as the denominator to be used in deriving the SBS charges, are all in dispute in this docket. Thus, there is no guarantee that storage costs and the revenues derived therefrom will remain close in the future. It therefore recommended synchronizing Nicor's costs with its revenues. It further asserted that, if the maximum storage allowance for Transportation customers is increased to an amount that is greater than 28 days, (discussed in Section VIII(C)(1)(a)) the presumptive billing units for storage service would be commensurately increased.

b. Nicor's Position

Nicor averred that its ECOSS accurately reflects the cost of storage by rate class. It asserted that the allocation of storage costs that it uses here is the same allocation that was approved by the Commission in its last rate case. Nicor argued that the Commission need not depart from a process that it repeatedly has approved. Nicor witness Mr. Mudra testified that, of the four transportation rate classes, only Rate 77 is projected to purchase slightly less than the storage allocated to it under Nicor's ECOSS. The remaining Transportation rate classes will actually purchase slightly more than their allocated amount. The difference between the storage amount allocated to Rate 77 and the projected storage that will be purchased is just $11,000. This difference is less than one half of one percent of the Rate 77 allocation. Nicor Initial Brief at 64.

c. Analysis and Conclusions

The parties agree that, under Nicor's allocation method for storage costs, Rate 77 Transportation customers would pay more than their fair share of storage costs, though currently a very small amount. While we acknowledge that the methodology used by Nicor to determine the allocation of storage costs was previously sanctioned by this Commission, no other reason has been articulated to continue this disparity. We agree with the IIEC that the better approach is to reallocate the cost of storage amongst Nicor's Transportation customers based on the revenues that Nicor receives from those customers.

While the present disparity between what Rate 77 customers pay and what other Transportation customers pay does not appear to be substantial, this disparity could increase as a result of this Order. It could also increase in the future if it were not corrected now. Also, the presumptive units for storage are increased in Section VIII(C)(1)(a), which is entitled "Storage Banking Service ("SBS") Entitlement. Other issues, such as the denominator of the SBS charge, (*See,* Section VIII(C)(2)(a), entitled "SBS Entitlement") have been changed herein. Therefore, it appears that the difference between what Rate 77 customers are charged and what other Transportation customers are charged may grow larger. The IIEC's proposed reallocation is hereby approved.

3. Interclass Allocation Issues

a. Rate 1 Allocation

Nicor proposed to move its residential customer class (Rate 1) revenue allocation closer to the actual cost of proving service to these customers by moving to a 97.5% from a 95% Rate 1 allocation, which was approved in Nicor's last rate case. The IIEC proposes assigning Nicor's residential customers to be assigned 100% of their cost of service. A move to assign 100% of the cost of service to Rate 1, as opposed to 97.5%, increases residential rates by an additional $12,000,000, and, it would reduce the rates of non-residential (commercial and industrial) customers by the same amount.

i. The IIEC's Position

The IIEC asserted that this Commission should impose its rate increase equally on all customer classes. It maintained that bringing Rate 1 customers to only 97.5% of

Nicor's cost of providing service to those customers, as well as setting Rates 76 and 77 at more than 106% of these customers' cost of service, just perpetuates inter-class subsidies. The IIEC argued that Rate 1 customers should pay 100% of the actual cost of providing service to those customers. Assuming that Nicor received total recovery in this docket, this result would be an increase to residential customers' rates by approximately, fifty cents per month. Tr. 327, IIEC Initial Brief at 11-3.

The IIEC stated that both Staff and Nicor support allocating Rate 1 costs on the basis of 97.5%, as opposed to 100%, based on the principle of gradualism, which, it asserted, must be applied in an even-handed and objective manner. *Id.* at 12.

The IIEC additionally averred that Nicor's ECOSS study implies that a cost-based increase for Rate 77 Transportation customers would increase base rates by nearly 46%. It concluded, if Rate 1 customers deserve to have their increase capped at below their full cost of service based on the principal of gradualism, Rate 77 deserves this same consideration. To do otherwise, it submitted, is undue discrimination, in violation of 220 ILCS 5/9-241. The IIEC concluded that assuming *arguendo* that this Commission finds that Nicor's Rate 1 increase should only be 97.5% of Rate 1's cost of service, this Commission should limit recuperation of the resulting shortfall to Rates 4 and 74. IIEC Initial Brief at 12-13.

ii. Nicor's Position

Nicor contended that, when it designed the rates here, it considered four major objectives: to recover its revenue requirement; to create cost-based rates; to provide equity and equalized rates of return across rate classes; and, to recover its fixed costs through fixed monthly service charges. In addressing these objectives, Nicor considered the rate-making principle of gradualism. Gradualism considers the overall impact that rate changes will have on customers. Nicor's Initial Brief at 65.

In Nicor's last rate case, this Commission concluded that it would be appropriate, in the interest of gradualism, to limit the revenue requirement increase to the residential customer class. In that proceeding, Nicor's residential customer class was assigned 95% of its full cost of service. In this proceeding, in an effort to move the residential customer class closer to its cost of service and still employ the principle of gradualism, Nicor proposed to assign the Rate 1 customer class at 97.5% of its cost of service. Nicor proposed to allocate the remaining revenue requirement among its non-residential customers based upon the Equalized Percent Embedded Cost method, which allocates the remaining revenues in the same proportions as was determined in Nicor's ECOSS.[12] *Id.* at 65-66.

Nicor further contended that the IIEC is incorrect in arguing that, if gradualism is employed for the benefit of Rate 1 customers, the same principle should be applied to Rate 77 customers. In so arguing, Nicor maintained that the IIEC did not state why this case is different from any other Commission rate case where inter-class subsidies have

[12] Nicor does not propose to recover the remaining revenue requirement from Rates 17 and 19 because the charges for those rates are established in long-term contracts. No party has disagreed with this contention. Nicor Initial Brief at 66.

been approved. As was the case in Nicor's 2004 Rate case, Nicor proposed to moderate the rate increase for residential customers. *Id.* at 60.

Nicor averred that this Commission should reject the IIEC's argument that, any Rate 1 revenue shortfall should be limited to Rates 4 and 74. Nicor contended that the IIEC presented no evidence to support this alternative. Also, according to Nicor, the IIEC did not explain why all other non-residential customer classes, Rates 5, 75, 6, 76, 7 and 77, should be excluded from bearing their proportionate share of the revenue shortfall. *Id.* at 60-61.

iii. Staff's Position

Staff posited that Nicor's proposed allocation is reasonable because Nicor determined the amount of these costs in a manner that balances between what Nicor actually incurs in costs, and, the principal of gradualism. Gradualism, Staff continued, is applied to the residential class here, as, this class receives an increase that moves it closer to, but not all the way toward, the full cost of providing this service. Staff Initial Brief at 75.

Staff contended that Nicor's proposed method of allocating its revenue requirement is a reasonable balance between utility costs and bill-impact concerns. However, the issue of how to consider the impact a bill has on a customer is a matter of judgment. Approximately 80% of Nicor's proposed rate increase would be paid by residential customers pursuant to the revenue allocation proposed by Nicor. If there were an additional movement toward allocating actual residential costs to residential customers, this percentage would further increase. Staff finally stated that, if the Commission were to adopt an increase that is smaller than that which Nicor proposes, the Nicor-proposed class revenues should be reduced on an equal percentage basis. *Id.* at 75-77.

iv. Analysis and Conclusions

We decline to impose 100% of residential customers' costs upon them at this time. We note that Nicor stated that it will do so in its next rate case. Also, pursuant to Nicor's proffered allocation, a commercial customer will see a reduction in the amount of costs it bears on behalf of residential customers. This gradually moves residential customers toward bearing the actual costs involved in providing natural gas to them. By moving gradually, we allow residential customers to be closer to what they actually incur, without imposing a "rate shock" upon these customers.

We also conclude that the IIEC has not provided evidence to support its conclusion that Rate 77 customers are suffering from a disparate impact of the rates imposed. Unjust discrimination, in the context here, requires a showing of a *McDonnell-Douglas* prima facie case establishing discrimination. *Citizens Utility Board v. Illinois Commerce Comm.,* 315 Ill. App. 3d 926, 938, 735 N.E.2d 92 (3rd Dist. 2000), *app. den.* 192 Ill. 2d 686 (2000); *McDonnell-Douglas Corp v. Green,* 411 U.S. 792, 93 S. Ct. 1815 (1973). The IIEC has not proven a *McDonnell-Douglas* prima facie case of discrimination. It also has not established that the inter-class subsidy here is different from other inter-class subsidies we have authorized in the past, many of which were greater than the one that Nicor proposes here.

We further reject the IIEC's argument that any shortfall from imposing 97.5% of Rate 1's actual cost of service should be borne, solely, by Rates 4 and 74. The IIEC has articulated no reason to indicate that this suggestion is fair, reasonable, or, supported by the record. We further note that the IIEC's assertion that Rate 77 customers' rates would increase by 46%, does not establish a disparate impact on those customers. The IIEC has not provided us with evidence as to what specific charges would be increased and what specific charges would be decreased. In short, the IIEC made a factual conclusion without specifying what facts underlie that conclusion. Therefore, we need not consider it. *Fraley v. City of Elgin,* 251 Ill App. 3d. 72, 76-77, 621 N.E.2d 276 (2nd Dist. 1993). We additionally note that Staff has pointed out that residential customers will bear 80% of Nicor's proposed rate increase. No party has contended that this is incorrect. This assertion is some indicia that the rate increase impact upon Rate 77 customers is not as disparate as the IIEC asserts.

Generally, this Commission does not impose rates without consideration of the principle of gradualism. The IIEC has given us no valid reason to deviate from this principal. We find Nicor's proposal to move the Rate 1 residential class closer to its actual cost of service to be reasonable and it is hereby approved.

VIII. RATE DESIGN

A. OVERVIEW

Nicor asked the Commission to approve its interclass allocation and rate design, which, it argues, reflects traditional ratemaking principles such as cost-causation and gradualism. To meet its rate design objectives, Nicor relied upon the results of its ECOSS, which, it contended, properly assigned costs to the customer rate classes causing those costs. The ECOSS determined the appropriate level of revenue requirement that is needed to achieve an equalized rate of return by rate class. Nicor then used the results of the ECOSS to move the existing rates closer to cost of service.

In addition to Rate 1 (residential service), Nicor has four sets of "companion" non-residential rates, which are, as follows:

Rate 4 – General Service and Rate 74 – General Transportation Service

Rate 5 – Seasonal Use Service and Rate 75 – Seasonal Use Transportation Service

Rate 6 – Large General Service and Rate 76 – Large General Transportation Service

Rate 7 – Large Volume Service and Rate 77 – Large Volume Transportation Service

Rates 4, 5, 6 and 7 are traditional "Sales" service rates that automatically enable customers to purchase 100% of their natural gas supply directly from Nicor. Rates 74, 75, 76 and 77 are "Transportation" services rates that enable customers to purchase their natural gas from third-party suppliers. The base rate charge for the companion rate classes were developed together. Also, Nicor removed the cost of storage service from its Transportation customers, which was accepted by this Commission in its last two rate cases. Nicor Initial Brief at 67-68.

B. **UNCONTESTED ISSUES**

1. Rate 6 and Rate 76 Design

Rates 6 and 76 are structured with monthly customer charges and flat distribution service charges for all therms delivered. Nicor proposed to increase to its monthly customer charge for the combined rate classes to recover a greater proportion of its fixed cost of service while maintaining the existing distribution charge for Rates 6 and 76 of, respectively, $0.266 and $0.189 per therm. *Id.* at 68.

Staff witness Mr. Lazare submitted proposed changes to the charges for Rates 6 and 76. These changes are to establish the monthly customer charge to only recover “customer costs” as is designated within the ECOSS, and, to increase the single distribution charge. However, Staff provided no testimony challenging Nicor’s proposed rate design for these rates. Staff also did not challenge Nicor’s rate design in pleadings or in briefs. It appears, therefore, that this issue is waived by Staff. *See,* Nicor Initial Brief at 68. We therefore approve Nicor’s proposal.

C. **CONTESTED ISSUES**

1. Rate 1 Design

Nicor proposed to move its current $8.40 Rate 1 monthly customer charge halfway toward a Straight-Fixed Variable (“SFV”) monthly customer charge of $18.66 and correspondingly decrease its declining block variable charges. Nicor’s monthly customer charge would increase to $13.55 on a monthly basis. Nicor proposed an SFV rate design to recover more of its fixed costs through its monthly customer charge, as opposed to via a volumetric charge. Thus, less of Nicor’s fixed costs would be recovered through its volumetric distribution charge.

Nicor also proposed an alternative SFV rate design should the Commission determine not to implement Rider VBA. This alternative recovers 80% of fixed delivery service costs through the monthly customer charge.

a. Nicor’s Position

i. Nicor’s Proposed Rate 1 SFV Rate Design

Nicor’s current residential rate design consists of a customer charge of $8.40 per month and a three-step declining block rate which is, $0.1473 per therm for the first 20 therms per month; $0.0579 per therm for the next 30 therms per month; and, $0.0519 per therm for all usage that is excess of 50 therms per month. The two primary changes proposed by Nicor to its Rate 1 customer class are: (1) an increase in the Monthly Customer Charge to $13.55; and (2) elimination of the existing second block of $.0579 per therm.

Nicor proposed to move its $8.40 Rate 1 monthly customer charge halfway toward an SFV monthly customer charge in the amount of $18.66. When half of this difference, or, $5.13, is added to the current charge in the amount of $8.40, the result is $13.53. The $13.53 figure was rounded up to $13.55. Nicor Ex. 14.0 at 17-18.

Due to the negligible price difference between the existing second block at $0.0579 per therm and the existing third block at $0.0519 per therm, Nicor proposed to eliminate the second block, and form one tail block for all usage over 20 therms per month at a rate of $0.0519 per therm. Nicor maintained that eliminating this rate step also gradually moves its rate design toward an SFV rate design. It argued that its proposed monthly customer charge would move it toward a middle-level in the range of current monthly charges, in comparison to the current monthly rates that other Illinois gas utilities charge.

Nicor additionally proposed to decrease the amount it charges for the first block, which covers residential customers' monthly base (non-heat) use, from $0.1473 per therm to $0.1271 per therm. Nicor averred that these moves allow it to recover more of its fixed, non-volumetric charges in its Rate 1 customer charge, with its volume-related costs to be recovered through blocks 1 and 2. Nicor Initial Brief at 69-70.

Nicor pointed out that recent Commission decisions have authorized a greater recovery of fixed costs through fixed monthly charges. In the 2007 Peoples Gas Rate Case, the Commission approved a four-year Rider VBA pilot program that ensured recovery of 100% of the fixed costs embedded within residential and small commercial volumetric distribution charges. In that case, this Commission found that Peoples Gas' Rider VBA reflected the particulars of declining and variable customer usage patterns and the concomitant revenue recovery impacts upon Peoples Gas. Similarly, in the 2007 Ameren Rate Case, the Commission found that recovery of a greater proportion of fixed delivery costs through a fixed monthly customer charge sends the proper price signals to customers and it also decreases any disincentive that a utility may have to implement gas efficiency programs. Nicor Initial Brief at 70-71.

Nicor opposed Staff's recommendation to replace its declining-block rate structure with a flat distribution structure. It additionally rejected Staff's proposal to impose an alternative declining block rate design. Nicor averred that Staff's two proposals would increase winter bills and decrease summer bills. Nicor concluded that Staff's proposals increase its exposure to the weather, as well as its customers' exposure to the weather. During cold weather, when natural gas usage is at its greatest, ratepayers' delivery bills could increase dramatically pursuant to Staff's proposal. *Id.* at 72-73.

Nicor maintained that its proposal to move from three to two blocks for its residential service distribution rates represents a gradual movement toward the flat distribution rate that was proposed by Staff witness Mr. Lazare. Aligning fixed costs with fixed charges, as opposed to charges based on volume, provides customers with accurate price signals for the cost of delivery service. It additionally provides Nicor with the opportunity to recover its costs. Nicor also averred that Staff's proposals "perpetuates the yo-yo effect" between winter and summer gas bills. *Id.*

Nicor's witness Mr. Mudra disputed the veracity of Staff witness Mr. Lazare's statement that distribution main costs are not fixed costs. Mr. Mudra stated that approximately 82% of all Rate 1 customers are connected to Nicor's standard, high pressure, 2-inch mains. This main investment, he concluded, is a fixed one that is appropriately recovered through a fixed charge imposed in the same amount on all residential customers. He further testified that Nicor's cost of providing service to residential customers is the same, regardless of the size of a customer's residence. In fact, the costs associated with delivering natural gas to customers, such as, gas mains, gas services, meters and regulators, are largely fixed costs. According to Mr. Mudra, 94% of the costs that Nicor incurs in providing service to residential customers are fixed costs. Only 6% of those costs depend on the volume of gas supplied to customers. He also stated that a fixed monthly price signal is more accurate than a seasonal price signal. This is true, he asserted, because Nicor's fixed investment in gas mains, service lines and meters are available to serve customers' needs 365 days a year. Nicor Ex. 48.0 at 18.

Nicor also opposed the AG/CUB proposal to establish residential customer charges by increasing all Rate 1 charges (the monthly customer charge and three volumetric distribution charges) by the same percentage increase that will be approved for Rate 1 in this proceeding. According to Nicor, this proposal exacerbates weather-sensitivity by increasing residential costs in the winter months, when gas usage is at it highest. Nicor's proposal, on the other hand, levels-out customer delivery charges, thereby reducing the strain on customers during the winter season. The AG/CUB proposal does not address the fact that Nicor's cost of serving residential customers is, for the most part, fixed. It is not driven by volume. Nicor Initial Brief at 74.

Nicor disputed the veracity of the information that AG/CUB witness Mr. Rubin used to support his statement that low-use customers' monthly percentage increase is more than the monthly percentage increase of other users. Mr. Rubin focused on the smallest 0.21% of Nicor's non-heating customers who use on average just 11 therms per year. According to Nicor, the dollar increases for all residential customers is very similar. The increase for the smallest-use non-heating customer is $5.13 per month. All other non-heating customers would receive a similar increase per month, ranging from $4.57 to $5.00. Similarly, while the smallest 3.97% of space heating customers would receive a monthly increase of $4.78, all other heating customers would receive monthly increases between $4.57 and $4.69. Nicor averred that therefore, the monthly impacts are not disparately imposed and they are not extreme, as was maintained by Mr. Rubin. *Id.* at 72.

Nicor additionally posited that its rate design reduces any existing intra-class subsidy that currently exists between low-use and high-use customers. Moving customers closer to their cost of service, it averred, is not a penalty, it is good rate design. Also, pursuant to Nicor's proposed rate design, distribution charges will be less than they are currently. Nicor Reply Brief at 73.

ii. Nicor's Alternative Rate 1 SFV Rate Design

Nicor proposed SFV rate design as an alternative to Rider VBA, if Rider VBA is not accepted. Specifically, Nicor requested that the Commission approve a Rate 1 monthly customer charge that recovers at least 80% of Nicor's fixed delivery service costs, but not less than the proposed $13.55 customer charge. With 94% of Nicor's residential costs being fixed, 80% of these fixed costs would result in a $14.65 monthly customer charge. Staff witness Lazare discussed the disadvantages of an SFV Rate Design, Staff Ex. 7.0, 34:734-47, but Nicor asserted that none of these claims had merit. Nicor Gas Ex. 29.0, 14:291-20:420 (Corr. Reb.).

iii. Rate 1 Design and Conservation

Nicor maintained that a higher per therm delivery charge should not be imposed on the residential customers under Rate 1. It argued that fixed costs should be more closely associated with fixed charges and not with volumetric charges, because customers will receive accurate price signals for delivery service. This proposal also provides Nicor with a reasonable opportunity to recover its costs. Nicor pointed out that its proposed Rider EEP will encourage customer conservation, and, Rider VBA will enable it to recover its fixed distribution costs, regardless of changes in weather or conservation. Nicor Initial Brief at 74.

In its Reply Brief, Nicor averred that a weakness in the Report Staff witness Mr. Lazare quoted as a basis for eliminating the declining blocks in Nicor's rate structure, (which was issued by the National Action Plan for Energy Efficiency) was that its conclusions are based on the consumers' consumption of electricity, not natural gas. According to Nicor, consumption of electricity is not the same as that of natural gas. Nicor Reply Brief at 64.

b. Staff's Position

i. Nicor's Proposed Rate 1 SFV Rate Design

Staff acknowledged that there is "no question" that recent Commission decisions have favored recovering the costs at issue here in the customer charge. It asserted, however, that those decisions are not binding here. Staff Initial Brief at 85.

Staff argued that Nicor's SFV approach reflects Nicor's erroneous argument that a greater share of system costs should be recovered through fixed customer charges. The problem with an SFV-based rate design from a cost-causation standpoint can best be illustrated by examining what would happen if Nicor imposed a full-SFV customer charge of $18.68 on residential customers. According to Staff, that charge would not only cover customer costs, but it would also cover demand costs. Staff opined that the costs that Nicor incurs for its distribution mains are demand costs, or, volumetric, costs, not fixed costs. Staff argued that thus, pursuant to Nicor's proposal, a residential customer in a house that is 1,000 square feet in size would pay the same for mains as a larger residential customer with a house that is 4,000 square feet in size, even though the larger of the two could be expected to use a larger share of main capacity. Staff concluded that a gap would emerge between the costs that these two customers incur and the bills that they would be asked to pay. Staff Initial Brief at 77-78, 80.

Staff also acknowledged that Mr. Mudra testified that the charges should be the same for both a customer with a 1,000 square foot house and the one with the 4,000 square foot house because Nicor pays the same costs for these two customers. Staff averred, however, that this contention fails to consider the relative share of mains, as a whole, that is used by each of these two customers. Given these relative shares, according to Staff, it does not make sense for these two customers to pay the same charge for main costs. Staff concluded that therefore, recovery of main costs in variable distribution charges is more appropriate. Also, the gas that residential customers receive passes through larger mains (larger than 2-inch) on the way to their residences. The size of those larger mains is determined, over the long run, by ratepayer demands. Staff Ex. 2.0 at 16-19.

It is inconsistent, Staff averred, for Nicor to consider its main costs to be demand-related in its ECOSS and then seek to recover those same costs through a fixed-cost customer charge in its rate design. According to Staff, in its ECOSS, Nicor regarded its main costs as ones that are driven by peak demands which occur during the winter. It concluded that recovering those costs equally each month of the year would not be logical from a cost-causation standpoint. Staff Initial Brief at 82.

According to Staff, customers experiencing financial distress would suffer, if this Commission were to impose an SFV-based rate design here. This is true, Staff asserted, because a full SFV rate design recovers a larger share of distribution costs through a fixed customer charge, thereby reducing a ratepayer's ability to lower his bill by consuming less gas. *Id.* at 83.

Staff further argued that the continuation of Nicor's declining- block structure should be rejected. A declining-block structure, it averred, conflicts with cost-causation principles. A declining-block assumes that ratepayer demands at lower consumption levels are more costly to serve than higher levels of demand, which penalizes smaller customers by assuming that they are most costly to serve on a per-unit basis. *Id.* at 87.

Staff proposed an alternative to the Nicor's proffered SFV charge. Staff's alternative is flat charges for usage and demand for residential and non-residential customers alike. This flat rate assumes that all therms of usage and demand are equally costly to serve on a per-unit basis. Staff concluded that its rate design most effectively reflects costs; it also promotes the efficient use of gas by ratepayers. *Id.*

Staff did not object to imposing higher winter natural gas bills upon consumers. Staff stated that there are good reasons to send price signals along in wintertime. The largest component of a gas bill is the cost of the gas itself. To the extent that higher winter rates dampen the winter demand for gas, Staff asserted that higher winter bills will relieve upward pressure on gas costs. Higher winter gas bills will also increase the cost-effectiveness of heating season conservation measures. *Id.* at 88.

ii. Nicor's Alternative Rate 1 SFV Rate Design

For the reasons Staff articulated in objection to Nicor's proposed SFV rate design, Staff also objected to this alternative rate design. Staff Initial Brief at 92.

iii. Rate 1 Design and Conservation

Staff argued that, by recovering a greater share of revenues through the fixed cost that cannot be bypassed, the SFV approach reduces ratepayer incentives to conserve gas. A higher fixed charge leads to lower volumetric charges, thereby reducing the amount of saving that ratepayers can realize by conserving gas. Staff stated that it is concerned that higher customer charges weaken the price signals for ratepayers to conserve gas. It also stated that this concern is shared by the National Action Plan for Energy Efficiency. This Plan finds that utility rates that are designed to promote sales, or maximize stable revenues, tend to lower the incentive for customers to adopt energy efficiency. It also found that rate forms like decline block rates, or rates with fixed charges, reduce the savings that customers can attain from adopting energy efficiency. Staff concluded that therefore, Nicor's proposal to stabilize its revenues by increasing its customer charges and reducing its variable charge under its SFV proposal, lowers, rather than increases, the incentive to engage in energy efficient behavior. Staff Initial Brief at 89-90.

Staff further contended that there are clear advantages to employing rate design as a tool to motivate conservation. The cost of implementing a rate design that encourages conservation is minimal, as the only requisite step is to reconfigure how bills are calculated. It asserted that it would be "counterproductive" for Nicor to undertake costly conservation program expenditure while failing to take advantage of the opportunity that rate design presents to "foster competition." *Id.* at 91. Staff additionally averred that Nicor's proposed Rider EEP will create a cost for the conservation programs that will be offered pursuant to that Rider. Staff concluded that it is counterproductive to focus on "expensive programs," while ignoring low-cost rate design. Staff Reply Brief at 33-34.

c. The AG's Position

i. Nicor's Proposed Rate 1 SFV Rate Design

AG/CUB witness Mr. Rubin testified that Nicor's averment that it is currently under-recovering its fixed costs from Rate 1 residential customers, is wrong. Mr. Rubin is of the opinion that Nicor is, in fact, over-recovering its fixed costs from these customers. He stated that Nicor recovered an average of $72.89 in fixed costs from its gas distribution charges from each customer in the 24 months beginning in August of 2006 and ending in July of 2008. This rate of recovery, he opined, exceeds Nicor's assumed level of collection by more than $2.80 per customer per year. This rate of collection was established in Nicor's last rate case, which was $70.05 per customer. The AG argued that therefore, the assumption underlying Nicor's proposal is disproven, and, Nicor's rate design proposal is unsupported. AG Initial Brief at 20-22.

The AG further asserted that, even if this Commission were to agree with Nicor's contention that it is not recovering all of its fixed costs from Rate 1 customers, Nicor's proposal should nevertheless be rejected because it creates disparate impacts that should be rejected by this Commission. The AG contended that Nicor's proposed rate design punishes those customers who use the least amount of Nicor's distribution network. It does this by imposing the largest percentage increase on the customers with the lowest levels of consumption. A customer who uses 20 therms per month pays $11.35 per month now. However, that customer would pay $16.09 per month, pursuant to Nicor's proposal, which is a 41.8% increase. On the other hand, the largest gas users would see their bills increase by less than 5%. AG/CUB Ex. 3.0 at 7.

Mr. Rubin pointed out that Nicor is proposing an overall 31.36% increase in rates to the residential class. Instead of increasing each separate rate element, (the customer charge and declining blocks) by the same percentage, Nicor is proposing a more than 60% increase in the customer charge (to $13.55 per month) and a reduction in the declining block rates. The first block for the first 20 therms per month will be reduced by more than 6% to $.1392 per therm. The second and third blocks would be consolidated, so that all usage in excess of 20 therms per month would be charged at the rate of $0.0519. Customers that use between 20 and 50 therms would receive a decrease in an amount that is more than 10%.

The AG maintained that Nicor's proposal to use an SFV rate design should be rejected. It asserted that Nicor's proposal would allow it to recover all of its fixed costs through the customer charge, with recovery of variable costs implemented through a very low per therm distribution charge, resulting in one in every four customers paying more than a 40% increase. *Id.*

The AG argued that with a full SFV rate, 2% of customers (the largest residential users) will receive a decrease, even in the face of a 31% overall rate increase. Also, 20% of Nicor's customers will receive an increase of 20% or less. These lower-than-average increases must be made up by someone paying higher rates; thus, according to the AG, pursuant to the SFV rate, every one in four customers would pay more than a 40% increase in the amount of these costs on an annual basis. AG Initial Brief at 24.

According to the AG, thousands of lower-use customers would pay an extra $70 per year above the 31% average increase, while, at the same time, thousands of higher-use customers would pay hundreds of dollars less per year. The AG maintained that SFV rates destroy any notion of ratemaking integrity, as these rates, according to the AG, will cause many low-use customers to pay more on an annual basis so that some high-use customers can pay less. The rate impacts conflict with the ratemaking principles of gradualism, rate continuity, equity and non-discrimination. The AG argued that these principles require this Commission to impose changes in rate structure in a manner that is as gradual as possible so that customers receive a consistent set of price signals. The AG recommended that any increase should be made to the customer charge, as well as the three distribution block charges, on an across-the-board basis. AG Initial Brief at 24-25.

d. Analysis and Conclusions

i. Nicor's Proposed Rate 1 SFV Rate Design

We note, at the outset, that the term "rate" as is used for an SFV rate, only refers to a specific portion of customers' bills, i.e., the cost of delivering the gas commodity to customers. It does not refer to the total utility bill. Thus, any increase to the rate imposed is an increase only to a portion of a Rate 1 customer's bill.

Staff recommends a flat (increased) charge that would include both demand and fixed cost charges. This recommendation, however, exposes consumers to greater cost increases during the wintertime, when gas is needed for winter heating, and, therefore, gas bills are already higher due to the inevitable increase in the amount of gas consumption that occurs to provide winter heat.

Additionally, while Staff states that higher winter bills will relieve upward pressure on gas costs, Staff provides no basis for this conclusion. Natural gas is for many a necessity, as, at a minimum, it often is a source of heat and hot water. It can be more difficult to decrease the amount that a person uses of an expensive item when it is a necessity.

The AG additionally argues that Nicor's proposed design disparately imposes greater costs upon residential customers that use less gas. However, Nicor presented evidence establishing that the increase for the smallest-use non-heating customer is $5.13 per month and all other non-heat customers would receive a similar increase per month, ranging from $4.57 to $5.00. Also, while the smallest 3.97% of space heating customers would receive a monthly increase of $4.78, all other heating customers would receive monthly increases between $4.57 and $4.69. The difference between the increase for the smaller customers and that for other customers is not great in terms of the actual monetary amounts.

Moreover, this argument ignores the fact that the evidence established that there is an intra-class subsidy amongst Rate 1 ratepayers. Because 94% of Nicor's fixed costs are the same, regardless of the size of a residence, currently, ratepayers owning larger residences pay a portion of the cost of supplying gas to smaller residences through the volumetric charges.

We also conclude that the AG's arguments on this issue are not persuasive. Mr. Rubin testified that Nicor actually received more money from each residential customer than it needed to recover through its rates. Mr. Rubin, however, bases this conclusion solely upon a comparison between the charges imposed by Nicor and the amount that was approved for those charges in Nicor's last rate case.

However, what this Commission determined in Nicor's last rate case (that Nicor was entitled to recover by way of a rate increase) is simply not the same as what Nicor's actual costs are or have been. A Commission determination as to what a utility is entitled to recover for a particular cost is an estimate, based on the evidence presented, as to what a utility will need in order to recover that cost. Over time, unforeseen events, (*e.g.,* Hurricanes Katrina and Rita) cost increases and other occurrences that were not predicted in a rate case can skew the accuracy of that estimate. Therefore, a comparison between what Nicor recovered and that which Nicor was permitted to charge in its last rate case, without more, does not establish that Nicor is recovering more than the actual costs it incurs. In fact, there is no evidence indicating that the costs Nicor seeks to impose do not accurately reflect what Nicor incurs on behalf of these customers on a fixed basis. This argument, therefore, is not persuasive.

Similarly, Staff argues that Nicor's proposal will have an adverse impact upon customers in financial distress because those customers will have less of an ability to control their gas bills by using less gas. Nicor's proposal would, however, provide a consumer with a more accurate prediction of his or her gas bill. And, such consumers would nevertheless still be able to manage the greater portion of their gas bills, which is, the portion of that bill that imposes the cost of the gas provided, as well as those charges, like taxes, that are determined based upon a percentage of a gas bill, by using less gas. Also, we note that Nicor is decreasing its volumetric charges. Any adverse impact upon a customer in financial distress, while unfortunate, would be negligible.

Staff also argues that a continuation of Nicor's declining-block structure should be rejected because it imposes a greater increase on lower-consuming ratepayers. This argument overlooks the fact that, in an effort to gradually move toward imposing actual costs upon Rate 1 residential customers, Nicor has decreased its declining blocks from three blocks to two. This change reflects a gradual movement, which lessens its impact upon consumers toward what Staff proposes as it moves from three blocks to two blocks. This argument, also, is not persuasive.

Staff also raised the argument that distribution mains are demand costs, or volumetric costs, not fixed costs. Staff provided an example of a 1,000 square foot house and a 4,000 square foot house where Staff asserted that the larger house would be expected to use a larger share of main capacity, but both customers would pay the same amount.

The Commission notes, as we did in our prior Ameren decision (Docket No. 07-0585 Cons., at 238), that, on average, the combination of increasing the fixed customer charge and decreasing the volumetric charges for fixed cost recovery is essentially a revenue neutral exercise. Staff apparently believes this rate structure would create an intra-class subsidy within Rate 1, whereby smaller customers would subsidize larger customers within the class. However, as stated in the Gas Distribution Rate Design Manual prepared by NARUC, rate classes should be defined "according to certain characteristics which are common to all members of the class." These characteristics can include size or load factors. To the extent that the Rate 1 residential class of customers may contain identifiable groups of customers that are not homogenous in their consumption or demand characteristics, the company should provide the Rate 1 customer, billing determinant information and any other statistical information necessary for Staff, the Company and any interested intervenors can to propose changes in the next rate case. Based on the record evidence provided, the Commission determines that an SFV rate design for Rate 1 is appropriate and accepts the Company's alternative SFV rate design as explained more fully below.

ii. Nicor's Alternative Rate 1 SFV Rate Design

Nicor proposed an alternative SFV rate design if the Commission denied Rider VBA. This alternative recovers 80% of Rate 1 customers' fixed delivery service costs through the monthly customer charge.

> In Docket 07-0585 (cons.), the Commission noted an alternative to Rider VBA that would still promote fixed cost recovery by the utility is recovery of a greater portion of fixed delivery costs through the fixed monthly charge to all affected customers. AIU makes this suggestion and

> notes that under this method, utilities could not over- or under-recover their Commission-approved base rate revenue requirement with changes in sales. AIU adds that this alternative would also send proper price signals to customers. The Commission concurs with these statements and notes further that this alternative arguably decreases any disincentive AIU may perceive to implementing gas efficiency programs. Docket 07-0585 (cons.) at 237.

And also that,

> While the Commission acknowledges that the monthly charges will increase and such increases may be more apparent on bills than changes to volumetric rates, the fact remains that the volumetric rates will decrease by a corresponding amount. Therefore, on average, there should be no overall adverse revenue impact on customers resulting from recovering a greater portion of fixed costs through the monthly customer charge than a volume based rate. *id*. at 238.

In addition, the Commission concluded that:

> AIU should modify its monthly customer charges for these classes to recover 80% of the fixed delivery services costs approved in this proceeding… The Commission anticipates that this method of recovering fixed delivery costs will be simpler and easier for customers to understand than Rider VBA. *id*. at 237.

Consistent with our decision in the 07-0585 Order and the evidence provided in this proceeding as cited above, the Commission accepts Nicor's alternative SFV rate design. In addition, as noted above, the Commission directs the Company to provide the necessary Rate 1 customer information in its next rate case filing with sufficient detail to allow Staff and other parties to determine the extent to which Rate 1 intra-class subsidies exist and, if so, the parties can provide the Commission alternative cost of service and rate design approaches to address the issue in that proceeding. As we have accepted the alternative SFV rate design for Rate 1, Rider VBA is herein denied.

iii. Rate 1 Design and Conservation

At issue here is whether Nicor's proposal to lower its per therm delivery charges will discourage customers from conserving natural gas. Staff argued that Nicor's proposed SFV charge will send the wrong message to residential consumers because it will diminish the per therm delivery charge, thus providing a disincentive for these consumers to conserve in their use of natural gas. As a general proposition, a higher rate, should discourage use. However, this assertion does not take into account the facts that are pertinent here. The portion of fixed costs that are currently recovered through a volumetric charge are in fact fixed costs, and thus cannot be conserved. During periods of rising fuel costs that result in consumer conservation of the gas commodity, the utility under-recovers its fixed costs of delivery. Moving a greater percentage of fixed cost recovery to fixed charges rather than volumetric charges provides a more stable revenue stream and sends a better price signal to the consumer.

Turning our focus to the import of Staff's reliance on the National Action Plan for Energy Efficiency, if Staff truly found the National Action Plan for Energy Efficiency to be compelling evidence, it would have entered that plan into evidence. It did not. Therefore, we cannot determine the extent to which it is truly comparable to the gas market. And, while Staff avers that a Nicor-sponsored energy efficiency plan would be costly, it presented no evidence in support of this claim.

The Commission is not convinced that an SFV rate design reduces the incentive to conserve natural gas. These costs are in fact fixed costs, cannot be conserved, and result in an under-recovery of fixed costs for the utility during periods of milder than average weather and an over-recovery of fixed costs for the utility during periods of colder than average weather. We conclude there is no disincentive a consumer may have by a move toward recovering fixed costs through fixed charges, as opposed to recovery on a volumetric basis. We further conclude that a Rate 1 design that more accurately reflects a consumer's actual costs does not impede conservation.

2. Rates 4 and 74 Design

Rates 4 and 74 are "companion" rates for Sales and Transportation customers, respectively. Nicor proposed a declining-block structure for the rates in these two classes. Staff proposed an alternative flat rate design for these two rate classes.

a. Nicor's Position

Nicor asserted that it developed base rate charges for Rates 4 and 74 based upon its ECOSS, which supports recovering 66% of its revenue requirement through the monthly customer charge. To move the rate design closer to the ECOSS results, approximately 50% of the Rates 4 and 74 revenue requirement, excluding the Transportation Administrative Charge and Recording Device Charge revenues, was allocated to the monthly customer charges. This increase was allocated in equal proportions to all three meter class sizes to achieve the base rate revenue requirement. Nicor Ex. 14 at 20-21.

Nicor argued that the alternative rate design proposed by Staff witness Mr. Lazare should be rejected. Mr. Lazare's alternative is that Nicor should replace its declining-block rate structures in Rates 4 and 74 with a flat distribution charge for these three rates. *Id.* at 21; Nicor Initial Brief at 75-76.

According to Nicor, its rate design for Rates 4 and 74 accurately reflects the load profile of the affected customers and it will provide Nicor with a reasonable opportunity to recover its revenue requirement. Nicor witness Mr. Mudra testified that the customers served by Rates 4 and 74 are not homogenous. He stated that it may be an appropriate rate design for residential customers (Rate 1 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; however, customers served under Rates 4 and 74 range in size from very small storefront companies using 30 therms per month to supply gas for their hot water heaters to large manufacturers using 65,000 therms per month. According to Mr. Mudra, Nicor's current rate structure should not be changed because it accurately reflects the load profile of the affected customers. Nicor Ex. 29.0 at 20.

Nicor maintained that its load profile can reasonably be expected to recover its load requirement. Nicor differentiates amongst the customers in these rate classes by using three different levels of Monthly Customer Charges based upon meter size. These customers are further differentiated by Nicor's existing three-step declining block rate structure. Nicor Ex. 14 at 20-21; Nicor Initial Brief at 76-77. Additionally, this Commission considered similar Staff proposals in Nicor's 2004 Rate Case and rejected them. Nicor contended that nothing has changed since that time and no witness has presented any additional evidence showing that the Commission erred in maintaining Nicor's current rate design structure. Nicor Reply Brief at 77-78.

b. Staff's Position

Staff proposed rates for Rates 4 and 74 customers based on the same principles that drove its residential rate proposals. These include customer charges that collect customer costs only and flat demand and usage charges to collect demand and usage-related costs. Staff Ex. 7.0 at 40-41.

Staff acknowledged that there is a disparity in size among Rates 4 and 74 customers, but, Staff stated that Nicor did not introduce any cost evidence in this proceeding to show that larger customers are less costly to serve on a per-therm basis than smaller customers within these classes. According to Staff, Mr. Mudra's testimony as to the disparity in size of Rates 4 and 74 customers should not justify Nicor's proposed declining block structure. Staff Ex. 20 at 24-25.

Staff contended that its proposed flat rate offers an advantage over Nicor's declining block structure from a conservation standpoint. Declining block rates undermine conservation by encouraging more, rather than less, consumption through an average price that declines as more gas is consumed. A flat rate, in comparison, increases the incentive to conserve by charging all usage at the same rate. Staff's proposed bundled rate increases for larger Rate 4 bundled customers have increases in the range of 4.10% to 4.25%. According to Staff, these increases are not onerous. Staff Initial Brief at 94.

c. Analysis and Conclusions

We agree with Nicor's contention that a flat rate should not be imposed upon the affected rate classes at this time. This same argument was rejected by this Commission in Nicor's last rate case. 2004 Nicor Rate Case Order at 151-52, 156. Staff asserts no new facts in support of this argument. Staff also does not state why this Commission's previous decision was incorrect. Nicor proposed a rate design in Rider 28, Rider VBA, that would separate or "decouple," the revenues it receives from its delivery charge, which is a volumetric charge, from fluctuations in its sales of natural gas. This "decoupling" would occur for Rates 1, 4 and 74. Nicor Initial Brief at 109. The Commission, in its decision accepting Nicor's alternative SFV rate design for Rate

1, set forth above, denied Rider VBA. The Company has provided no apparent alternative 80% rate design for the Rate 4 and 74 tariffs in the event VBA is denied. Therefore, for the reasons set forth with regard to rate design for Rate 1, we find that here, Staff's proposed rate design should be rejected and the Company's proposed rate design as set forth in Nicor's Exhibit 14.0, recovering 50% of the Rates 4 and 74 revenue requirement through monthly customer charges, is accepted.

3. Rates 5 and 75 Design

No party contested Nicor's proposed rate design for Rates 5 and 75. These rates are hereby approved.

4. The Annual Therm Limitation

Initially, Nicor opposed the increase in therm limitation that was proposed by Vanguard and by Staff. After further discussions with Vanguard, Nicor agreed to recommend an increase in the limit for eligibility in Rates 5 and 75 to 700,000 therms. Staff did not take issue with this limitation; however, Staff recommended approving rates based on an assumption of 10% subscription. Staff Initial Brief at 96.

a. Staff's Position

Staff supported the Nicor/Vanguard's proposal. Staff asserted, however, that the assumptions for designing rates concerning the percentage of eligible customers that will subscribe to seasonal service are not correct. If the assumptions about migration to this rate are incorrect, Nicor will either over-recover or under-recover its revenue requirement. Staff Initial Brief at 96.

Staff asserted that the most reasonable assumption for ratemaking purposes is that 10% of eligible customers subscribe to seasonal service because, currently, only 10% of eligible customers subscribe to seasonal service. Staff averred that the behavior of existing customers provides the most useful guide to decision-making by newly-eligible customers for the rate. In support, Staff cited Nicor witness Mr. Mudra, who testified that: "few, if any, of these customers would actually subscribe to Rates 5 and 75 services." Nicor Ex. 48.0 at 27. Given these low expectations, Staff maintained that any assumption beyond a 10% participation rate would unduly favor Nicor and create the potential for over-earnings.

b. CNE's Position

On Exceptions, CNE argued that there is no historical evidence, upon which, to project subscription of seasonal service. It asserted that it is unreasonable to assume that each and every one of the newly-eligible subscribers to this service will transfer to Rates 5 and 75. CNE Brief on Exceptions at 3. In the absence of evidence establishing that 100% of these newly-eligible subscribers will transfer to the rates in question, CNE argued that Staff's proposal should be adopted. *Id.* at 4; *see also* attachment to CNE Brief on Exceptions at 2.

c. Nicor's Position

Nicor opposed Staff's customer subscription rate proposal. Nicor averred that Staff's proposal places Nicor in jeopardy of not recovering its costs. According to Nicor, Staff's recommendation does not consider that raising the therm limitation greatly expands the universe of potential applicants and the number of expected applicants for these rates. The expected volume of therms delivered under Rates 5 and 75 must be properly estimated in the final rate design. According to Nicor, Staff is speculating about the new number of applicants. Nicor Ex. 29.0 at 22-23.

For rate design purposes, Nicor proposed to utilize its undisputed test-year forecast of approximately 63 Rate 5 customers using 4,333,000 therms per year, and 22 Rate 75 customers using 3,650,000 therms per year, as was shown on Nicor Exhibit 48.3. Nicor asserted that this is approximately equivalent to Staff's proposal of assuming a 10% customer subscription rate. In addition, Nicor continued, it is more realistic to include that all newly eligible, large-volume customers that use more than the existing 250,000 therms per year limit, but less than 700,000 therms per year in the rate design. These newly-eligible large-volume users will realize the greatest economic benefit from rate-switching, and these customers regularly work with Transportation suppliers in selecting their rates. Nicor argued that therefore, it is realistic to assume that 100% of the larger-volume users will switch to Seasonal Rates 5 and 75. *Id.* This compromise, Nicor surmised, will reflect the continuation of the 10% subscription rate for the existing smaller-volume users, and it will also provide Nicor with a more realistic opportunity to recover its costs than Staff's proposal. Nicor Reply Brief at 79-80.

d. Analysis and Conclusions

The evidence demonstrates that the agreement between Nicor and Vanguard to expand the annual therm limitation for these two customer classes from 250,000 therms per year to 700,000 therms per year is reasonable and it is hereby approved. However, we agree with Nicor's contention that Staff's proposed rate treatment is not warranted at this time. With regard to customers who use below 250,000 therms per year, it is reasonable to design rates assuming a 10% subscription rate based on historical evidence for these smaller customers. However, at this time, there is no historical evidence upon which to draw for larger customers. We also agree with Nicor's argument that, due to the Nicor-Vanguard agreement, the large increase in the annual therm limitation for Rates 5 and 75 will result in newly-eligible, sophisticated, large-volume users realizing the greater economic benefit from switching to Rates 5 and 75. Staff's arguments do not address the shift that could occur as a result of Nicor's decision to increase its annual therm limitation for the affected rate classes.

While CNE has presented a logical argument that not all of the eligible subscribers will switch to the rate classes in question due to the expanded annual therm limitation for these classes, CNE merely asserts that Staff's recommendation should be adopted. It could have, but did not, provide evidence as to how many subscribers actually will switch to these rate classes due to the expanded annual therm limitation for these classes.

On the other hand, Nicor's proposed compromise (Nicor Ex. 48.3) reflects 10% subscription (approximately) and, also, an estimate of the number of expected customers that will take advantage of the increased therm limitation.

We are left with Staff's recommendation, which is obviously too low, and, Nicor's recommendation, which, in all probability, (due to the sophistication of the customers involved) will only be slightly too high, at best. No party or Staff has provided us with a reasonable means to determine how many eligible subscribers to these rate classes will not subscribe to these rate classes. Based on the limited evidence provided, we conclude that Nicor's proffered method is the most accurate. However, this ruling is based on the limited evidence provided on this issue. It has no precedential value. Nicor's alternative proposal (Nicor Ex. 48.3) is therefore approved.

5. Rates 7 and 77 Design

Rates 7 and 77 serve larger customers. Nicor's proposed rate design for Rates 7 and 77 consists of a monthly customer charge, a two-tiered (two blocks) demand charge, and, a flat distribution service charge for all therms delivered. As was the case for other rates, Staff proposed to eliminate the tiers and charge one flat rate. Both Nicor and the IIEC oppose Staff's proposed changes. *See, e.g.,* Nicor Initial Brief at 77-78; IIEC Initial Brief at 14-16.

a. The IIEC's Position

The IIEC posited that Staff's proposed changes to the rate design should be rejected. It asserted that Staff's proposal to increase the tail block demand charge in these rates (which are applicable to all therms above 10,000) from 2.63 cents per therm to 29.00 cents per therm, represents, approximately, an increase of 1,000%. Citing Staff witness Mr. Lazare's testimony at trial, the IIEC averred that the tail block demand charge is about 80% of the billing demand units for Rate 77 customers. IIEC Initial Brief at 14; Tr. 531.

The IIEC submitted that, on its face, a 1,000% increase violates the principle of gradualism. It averred that such an increase could produce close to triple-digit increases for some Rate 77 customers. Also, according to the IIEC, Mr. Lazare did not adequately consider the rate impacts of his proposal. The largest-size customer on Mr. Lazare's bill comparison used only 500,000 therms. The IIEC averred, however, that the average customer on Rate 77 uses one million therms per month. Also, some customers on Rate 77 use several times that amount. IIEC Ex. 2.0 at 25-26.

The IIEC further averred that Staff's justification for its proposal is minimal. It maintained that Staff's proposed changes are due to Mr. Lazare's belief that imposing a flat rate, as opposed to imposing demand charges in blocks, will lead to conservation. Additionally, it noted, Mr. Lazare was focused principally on declining block consumption charges for Rate 1 residential customers, not the declining block demand charge for Rates 7 and 77. IIEC Initial Brief at 14-15.

It also asserted that Staff's proposal to eliminate the declining block structure on the demand charge is not cost-based. The IIEC's witness Dr. Rosenberg testified that there are economies of scale involved in serving larger load. This testimony went unchallenged. IIEC Ex. 2.0 at 27-28.

Finally, the IIEC argued that Mr. Lazare's proposal to eliminate the declining block would greatly magnify the impact, for better or for worse, on Nicor's revenues, if the demand of those large customers were to change from the amount of use that he presumed when making his recommendation. If usage were to increase, Nicor could experience windfall profits. On the other hand, if such usage were to decrease due to Mr. Lazare's proposal, Nicor's profits could suffer, which could help precipitate another rate case. IIEC Initial Brief at 15-16.

b. Nicor's Position

Nicor averred that this Commission should reject Staff's proposals for Rates 7 and 77. It maintained that Rates 7 and 77 were designed together to approximate the $14,426,000 base rate revenue allocation derived from the EPEC method, excluding the forecasted Transportation Administrative Charge revenues and rounding adjustments. Nicor increased the limits on its Rate 7 and 77 monthly customer charges to match the increases to Rates 6 and 76, while maintaining the existing distribution charge of $0.0052 per therm. The Rate 7 demand charges were designed to recover the remaining revenue requirement. Also, the Rate 77 demand charges were increased in approximately the same proportions. The resulting rate structure for Rates 7 and 77, Nicor contended, recovers more fixed costs through fixed customer charges and demand charges, while still retaining the existing flat distribution charge. Nicor Initial Brief at 78-79.

c. Staff's Position

Staff proposed rates for Rates 7 and 77 customers based on the same principles that drove its rate design for other residential and nonresidential customers, which are, customer charges that collect customer costs only and flat charges to collect remaining costs. Staff Ex. 7 at 40-41. Staff cited the IIEC witness Dr. Rosenberg, who testified that the economies of scale are as follows:

> This is because larger loads are served with larger diameter mains. In fact, the capacity of a main increases more than with the square of the diameter. Thus, for example, the capacity of a 4-inch main is more than four times the capacity of a 2-inch main, and the capacity of a 6-inch main is more than nine times the capacity of a 2-inch main. However, the cost of the main per foot increases less than linearly in proportion to the diameter. Thus, for example, the per foot cost of a 4-inch main is less than twice the cost of a 2-inch main, and the per foot cost of a 6-inch main is less than three times the capacity of a 2-inch main. Thus, when you do the math, the cost per unit of capacity of a larger diameter main is much less than it is for a smaller diameter main.

See, IIEC Ex. 2.0 at 27-28.

Staff argued that Dr. Rosenberg made no effort to tie this discussion to the costs of serving small and large customers within the affected rate classes. According to Staff, the IIEC presented no evidence to show that larger customers within the affected classes are less costly to serve on a per-unit basis than smaller customers. In Staff's view, the fact that "the per foot cost of a 4-inch main is less than twice the cost of a 2-inch main, and the per foot cost of a 6-inch main is less than three times the capacity of a 2-inch main" does not justify Nicor's proposed rate structure. Staff Initial Brief at 97.

Staff additionally contended that customers taking gas pursuant to Rate 77 will not realize a disproportionate increase in the total amount they pay for gas service as a result of Staff's proposed rates. The average distribution charge for a Rate 77 customer is currently 3.2 cents per therm. The average market price for natural gas is about 65 cents per therm. Thus, the 3.2 cents per therm charge represents less than 5% of that average market price for natural gas. This, according to Staff, demonstrates that base rates represent only a small portion of the total amount that these customers pay for gas. Therefore, even if base rates were to increase significantly, the overall cost for gas services for these customers would increase in a modest amount. Staff Reply Brief at 38-39.

d. Analysis and Conclusions

We conclude that Staff's proposed changes to the rates at issue must be rejected. Staff has not controverted the IIEC's contention that, pursuant to Staff's rate design, the tail (second) block demand charge, which affects over 80% of Rate 77's billing units, would result in a triple-digit increase. According to the IIEC, the tail block demand charge in these rates, which are applicable to all therms above 10,000, would increase from 2.63 cents per therm to 29.00 cents per therm, resulting in an increase of 1,000% or more. Staff has not stated fact establishing that this averment is not correct. Staff also has not refuted the IIEC's contention that Mr. Lazare's bill comparison was based on only 500,000 therms, while the average Rate 77 customer uses one million therms per month.

Staff's argument that base rates only represent a small portion (less than 5%) of the average current Rate 77 charge is not persuasive. Staff fails to state how the relationship between Nicor's current charges and the current market price for natural gas establishes that its proposed rate structure is modest. Notably, Staff is silent as to what a Rate 77 customer would actually pay pursuant to its proposed rates.

We disagree with Staff's contention that the IIEC's arguments must be dismissed because the IIEC did not establish that the larger Rate 77 customers are less costly to serve on a per-unit basis than smaller customers. Dr. Rosenberg's testimony, cited above, did establish that generally, larger customers are less costly to serve than smaller customers. And, the IIEC did establish that Staff's proposal contravenes the principle of gradualism. Nothing further is necessary to prove that Staff's proposed rate design should be rejected. Nicor's proposed rates are hereby approved.

IX. TARIFF REVISIONS AFFECTING TRANSPORTATION CUSTOMERS

A. OVERVIEW

Nicor proposed to update certain charges and factors that relate to its Transportation Charges.

B. UNCONTESTED ISSUES

1. Individual and Group Administration Charges

Nicor proposed to update the individual and group Administrative Charges in Rates 74 and 75. The Individual Account Administrative Charge would be reduced to $23.00 per month and the Group Accounts will be charged $10.00 per month per account, with a minimum group charge of $33.00. Nicor Ex. 14.0 at 26. Staff and the Intervenors have not challenged these proposed revisions. We therefore conclude that these charges should be approved.

2. Recording Device Charges

Nicor proposed to increase the monthly Recording Device Charges for Rates 74 and 75 to $10.00 per month for diaphragm meters and $17.00 per month for all other meter types. Staff and the Intervenors have not challenged the proposed increase. We therefore conclude that these charges should be approved.

3. Group Change Fees

Nicor proposed increasing the Group Change Fee, which is applicable when suppliers change the accounts that are included in a group, from $15 to $25. In addition, it proposed increasing the Group Charge under Rider 13, Supplier Transportation Service from $35 to $95 per month. Staff and Intervenors have not challenged these proposed revisions. We therefore conclude that these charges should be approved.

4. Transportation Service Credit

Nicor proposed to update the Transportation Service Credit (a “TSC”), which applies to customers served under Riders 15, Customer Select, and 25, Firm Transportation Service. Nicor Ex.14.0 at 28.

In addition, as part of the Memorandum of Understanding (an “MOU”) negotiated with the Customer Select Gas Suppliers, Nicor proposed that Customer Select customers should receive a credit for the revenue requirement associated with gas in storage as part of the TSC. The per therm credit of $0.0045 per therm for gas in storage for the Company’s Customer Select customers is reflected in Nicor’s proposed tariff, Rider 15, Sheet 75.1. Nicor Ex. 48.1, page 113. Staff and the Intervenors have not challenged these proposed revisions. We therefore conclude that these charges should be approved.

5. Gas Supply Cost / Demand Gas Cost

See Section IX.C.2.c.i. (Storage Withdrawal Constant), below.

6. Timing of the Maximum Daily Contract Quantity ("MDCQ")

Based upon negotiations between the parties, Vanguard and Nicor reached agreement on this issue; Vanguard has withdrawn its proposed change to the MDCQ annual calculation. Tr. 631. Nicor's MDCQ annual re-determination period remains, therefore unchanged and unchallenged. It is therefore approved.

C. CONTESTED ISSUES

1. Reduction of Maximum Daily Nominations (the"MDN") in the months of July through October, and in the Months of March and April[13]

A Transportation customer's MDN is the maximum amount of gas that a customer can nominate for delivery into Nicor's system on any give day. A Transportation customer's MDN is currently applicable in the months of April through October. However, Nicor has agreed to term its daily nomination limits as MDN throughout the year.

Pursuant to Nicor's current tariffs, the MDN for any of the months in question is calculated for each month by adding: (1) the customer's historical monthly usage for the month, and (2) 25% of the customer's Storage Banking Service ("SBS") capacity, with the resulting volume then converted to a daily rate by dividing it by the number of days in the month. Nicor Ex. 4.0 at 24.

a. Nicor's Proposals with Regard to the Months of July through October

Originally, Nicor proposed to change the second part of this calculation for the months of July through October. It proposed to change the storage injection quantity portion of a customer's MDN from 25% of a customer's SBS capacity to 25% of a customer's open capacity as of April 30th. A customer's open capacity as of April 30th is the difference between the customer's capacity and the amount of gas in storage. Nicor Exs. 4.0 at 24; 38.0 at 33.

In its Initial Brief, CNE argued that the Commission should reject Nicor's proposed changes to the MDN. However, since that time, Nicor and CNE reached an agreement which moderates the impact of Nicor's proposed changes on Transportation customers. In fact, Nicor has agreed not to impose any changes on MDNs in the months of July through October. These two parties agreed that the MDN in the months

[13] Nicor does not propose any change to MDN criteria for the months of May and June. Nicor Ex. 4.0 at 26.

of July through October will remain at the "comparable month historical usage plus 25% of SBS capacity." CNE Reply Brief at 6. [14]

b. Nicor's Proposals with Regard to the Months of March and April

Originally, Nicor proposed to reduce March's daily nomination limit on non-Critical Days for Transportation customers from two times (200% of) their MDCQ (their Maximum Daily Contract Quantity) to 150% of a customer's historical usage, which is calculated on a daily basis. Nicor also proposed to limit the amount of inventory that these customers can inject into storage in April by changing April's MDN on non-Critical Days from their historical usage, calculated on a daily basis, plus 25% of their storage capacity, to 110% of their historical usage, also calculated on a daily basis. Nicor Ex. 4.0 at 28-29.

Subsequently, Nicor entered into an agreement with CNE whereby it would limit the MDN in the month of March to one time the MDCQ, (100%), which is half of Nicor's current requirement of two times the MDCQ (200%). In addition, CNE and Nicor agreed that the MDN in the month of April will change to a customer's Historical April Usage, plus 8% of a customer's SBS capacity rights. This is reduced from the current charge, which is, Historical April Usage, plus 25% of a customer's SBS capacity rights. April nomination rights for the SBS component of MDN are approximately 33% less pursuant to this agreement than they currently are. CNE recommended that the Commission adopt these terms. CNE Reply Brief at 6-7.

Although Staff has proposed an alternative to the MDN reductions that Nicor seeks to impose, Staff proposes this alternative only if this Commission determines that any reductions are warranted. Staff argued that no changes to the existing MDN limitations are, in fact, warranted. The IIEC, also, argues that no changes are warranted.

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[14] It could appear that the agreement reached between CNE and Nicor would end Commission discussion of this issue, as, in effect, it resolves this issue in a manner that the IIEC and Staff seek, that is, Nicor agreed to impose no change upon Transportation customers during the months in question. However, Nicor asserted in its Reply Brief that:

> [B]ased on post-hearing discussions, Nicor Gas and CNE have agreed upon a resolution of this issue. Nicor Gas agrees to withdraw its proposed change to MDN rights for July through October. As such, current nomination rights for those months will remain intact. *The Company's withdrawal of its July through October MDN reduction proposal is contingent upon the Commission approving the agreed upon March and April MDN reductions and the agreed upon on-system storage capacity level.*

Nicor Reply Brief at 84-85; emphasis added. Because we do not approve the agreed-upon (agreed-upon between CNE and Nicor) March and April MDN reductions and the agreed-upon system storage capacity level for those months, Nicor's proposed changes for the month of July through October remain in controversy.

i. The IIEC's Position

The IIEC is not a party to the CNE/Nicor Agreement. The IIEC opposed any reduction in MDNs. The IIEC contended that Nicor's proposals will restrict the amount of gas that Transportations customers can place in storage. Transportation customers' gas injections, or, what is also known as their "increases to its storage account," are deemed to be the positive difference between a customer's nomination for a particular day and its usage for that day. Nicor's proposed changes, the IIEC asserted, add to an industrial customer's cost of energy and they will diminish the flexibility that Transportation customers have in economically managing their gas supplies. Nicor's proposals will make it more difficult for customers to fill their storage banks to their total capacity. IIEC Initial Brief at 16-17.

The IIEC also argued that Nicor's position on this issue is contrary to Commission policy. In Nicor's last rate case, the Commission ruled that:

> The Commission rejects Nicor's proposed change. To the extent possible, the Commission would prefer to increase rather than reduce the flexibility of customers, whether Transportation customers or Customer Select customers. Nicor has been operating under an existing maximum daily nomination for many years. While the Commission can understand Nicor's argument that storage injections in winter are inconsistent with Nicor's objectives to fully cycle its storage fields, winter injections also seem fully consistent with Nicor's objective of maintaining sufficient gas in storage to meet late winter demands for significant storage withdrawals.
>
> The record contains no analysis that demonstrates Transportation customers intentionally interfere with Nicor's efforts to cycle its storage fields or that the activities of Transportation customers have ever actually interfered with Nicor's efforts to cycle its storage fields. In the absence of additional empirical evidence or a more compelling argument, the Commission has no choice but to reject Nicor's proposal.

See, Nicor Rate Case Order at 131. The IIEC argued that Nicor again proposes to change the terms and conditions, under which, it has successfully operated its storage fields, with no evidence that there is a problem, or, that its proposed change will solve any problem. IIEC Initial Brief at 17.

It asserted that Nicor has produced no evidence establishing that any harm would result, if this Commission were to decide not to impose any restrictions on Transportation customers. It maintained that, when asked in discovery if Nicor had studies showing the impact of Transportation customers' use of SBS on the cost of purchased gas for Sales customers, Nicor replied that it had none. IIEC Ex. 1.0 at 17.

The IIEC disputed the veracity of Nicor Ex. 19.3, which was prepared by Nicor's witness Mr. Bartlett. It posited that Nicor Ex. 19.3 is fatally flawed because it presumes that Nicor always physically injects or withdraws the exact amount of gas that is specified in its storage plan, citing the transcripts from trial. The IIEC averred that, in fact, Nicor can, and does, deviate from its storage plan for reasons like the weather.

Nicor's reasons for deviating from its storage plan do not involve the activities of any of Nicor's Transportation customers. Tr. 187,189-191; Nicor Initial Brief at 18.

The IIEC also averred that Exhibit 19.3 presumes that when Transportation customers withdraw more (or less), or inject more (or less), than their "proportionate" share of the storage plan, that variance must be made up at the difference between the Chicago City Gate Price and the settlement price for the NYMEX futures for the prompt month, citing the transcripts from trial.[15] The IIEC asserted that nowhere did Nicor demonstrate this is actually the case, citing Tr. 187, 197-200. It averred that, in fact, the evidence establishes that Nicor does not make up this variance at the difference between the Chicago City Gate Price and the settlement price for the NYMEX futures. For example, it asserted, Nicor has conceded that for the twelve-month period encompassed by Exhibit 19.3, however, Nicor did not purchase any gas at the NYMEX futures prompt month price. Nicor Initial Brief at 18-19; Tr. 199-200.

The IIEC also maintained that Exhibit 19.3 focuses solely on daily fluctuations in the price of gas, which does not take seasonal price differentials into account. Consequently, Mr. Bartlett could not describe what the impact would be on Sales customers, if seasonal differentials were to be incorporated into the analysis in that document. IIEC Initial Brief at 18-19, citing, Tr. 185-86. The IIEC additionally submitted that the analysis in Nicor Exhibit 19.3 has been thoroughly discredited by the testimony of Dr. Rosenberg, and Mr. Sackett, as well as the cross-examination of its sponsor, Mr. Bartlett. It argued that even assuming that Nicor's Ex. 19.3 does demonstrate the existence of a "problem" caused by Transportation customers, Nicor did not state how its proposed restrictions would solve any "problem." IIEC Ex. 2.0 at 35-37; Tr. 184.

It further contended that its witness Dr. Rosenberg, in his testimony, noted that Nicor has been able to satisfactorily operate its storage fields without the new restrictions Nicor proposes here. IIEC Ex. 1.0 at 17. Mr. Bartlett, who sponsored Nicor's MDN changes, acknowledged that Dr. Rosenberg is correct in his observation. IIEC Initial Brief at 20; Tr. 216.

ii. Staff's Position

Staff is not a party to the CNE/Nicor agreement. Staff's primary proposal is to make no changes from the current tariff provisions. However, in Rebuttal testimony, Staff witness Mr. Sackett offered a "fall-back position," if the Commission does not accept Staff's primary proposal. Staff Ex. 24.0R2 at 13-14. This "fall-back" proposal is as follows:

As an alternative to Nicor's proposed changes, Staff proposed to reduce by half (50%) Nicor's' proposed reduction in injection rights for the months of March and April. Nicor accepted Staff's proposal for the months of March and April; thus, Staff and Nicor agreed to the following clarifications: (1) for the month of March, Nicor would change the injection rights afforded under its current proposal from 150% of a customer's historical March usage to 200% of a customer's historical March usage; and (2) for the

[15] The "prompt month" is the following month. Tr. 199-200.

month of April, Nicor would change the injection rights afforded under its current proposal from 110% of a customer's historical April usage to 120% of a customer's historical April usage. Staff Ex. 24.0R2 at 14.

Staff maintained that its alternate proposal, with Nicor's clarifications, is superior to Nicor's primary proposal. Staff contended that this proposal provides more modest restrictions on customers who have retained storage balances at the end of the withdrawal period. However, Staff's preference is that the Commission conclude that the pertinent tariff provisions remain as they currently are. Staff Initial Brief at 102.

Staff argued that in Nicor's last rate case, Docket 04-0779, Nicor made a similar proposal, which was rejected by the Commission. Staff maintained that there are only three differences between the current proposal and that made Nicor's last rate case, Docket 04-0779. The first difference is the date on which the reduction is calculated. The second difference is the exclusion of May and June from the penalty months in the current proposal. These months are excluded because Nicor cannot incorporate its numbers quickly enough. According to Staff, the third difference, which is, to eliminate the 10% grace window, is the only substantive change between what Nicor proposes now and what it proposed in its last rate case. The grace window allowed Transportation customers to retain 10% of their Storage Banking Service ("SBS") in storage without affecting their injection rights. Staff Ex. 24.0R2 at 7-8.

Staff asserted that the modifications that Nicor proposes here are more stringent than the requirements that the Commission rejected in Nicor's last rate case. According to Staff, Nicor's new proposal would penalize the Transportation customers that cannot cycle 100% of their banks. Nicor now proposes to apply the same penalty as the one proposed in Nicor's last rate case, but, at the same time, it eliminated the 10% grace window that would have required Transportation customers to only cycle 90% of their gas capacity in order to maintain current injection rights. Staff Initial Brief at 104.

Staff argued that there has been no decrease in storage field performance from the current nomination rights, citing IIEC Ex. 1.0 at 16. According to Staff, Mr. Bartlett stated several times that, currently, Nicor's storage fields are performing well and, their pressures are up. Staff Reply Brief at 41-42.

Staff further contended that Nicor has not issued any caps on interstate pipeline deliveries in the past 16 months. Staff concluded that therefore, Nicor did not establish that tightening its nomination levels will have a material effect on the number of caps that Nicor will need to issue. Finally, Staff contended that Nicor has offered no studies or testimony to demonstrate that the reduction levels it proposes are optimal or even appropriate. Staff Initial Brief at 104-105; 108-109.

iii. Nicor's Position

Nicor argued that it is necessary to change Transportation customers' daily nomination limits. Nicor witness Mr. Bartlett testified that, from an operational perspective, Nicor's proposed changes to its daily nomination limit more closely match customers' storage use with actual storage field operating requirements. He also testified that such changes are expected to reduce the additional costs which Sales customers are forced to incur, due to Transportation customers' storage usage patterns. Nicor Ex. 19.0 at 14.

According to Mr. Bartlett, the proposed changes to its MDN calculation will help reduce the potential need for Nicor to "cap" pipeline deliveries for those days during the injection season in which too much gas is being nominated to its system relative to the level of injections that can be physically accommodated by the storage fields. He stated that: "Nicor has had to cap, or limit, pipeline deliveries to its system several times over the last few years in order to protect the operational integrity of its system and storage fields." He further stated that often times, these cap periods were for several days, even weeks. And, Nicor "has heard" from its shippers that caps are disruptive. Nicor's changes would, according to Mr. Bartlett, reduce the chance that Nicor would have to impose pipeline caps. Nicor Ex. 44.0 at 29.

Mr. Bartlett testified that that March and April are critical months for ensuring that Nicor is operationally able to cycle gas in its inventory. These months are problematic, because, as the weather begins to warm, customer usage declines. Yet, at the same time, withdrawals from Nicor's aquifer fields are operationally required to achieve maximum cycling. The disadvantage to Nicor, if targeted levels of gas in inventory are not cycled, is a decline in reservoir performance, which increases the potential for the non-cycled gas to become ineffective. Also, if gas in inventory is not cycled, this could result in lower reservoir pressures going into the next withdrawal season, which translates into reduced deliverability. Nicor Ex. 4.0 at 27.

Historically, Mr. Bartlett testified, Transportation customers typically inject into their storage accounts during the months of March and April when, operationally, Nicor needs to be withdrawing from storage. The potential March storage activity by Transportation customers is adverse to Nicor's physical storage operations, he stated, given that Nicor needs to be "on withdrawal" to maintain optimal field performance and avoid degrading the integrity of the fields. This is why Nicor proposed to reduce Transportation customers' daily nomination limit. Nicor Ex. 4.0 at 28.

Nicor additionally asserted that the operational storage plan used in Nicor Exhibit 19.3 is not some "hypothetical" ideal. Rather, it is a reasonable working plan that is implemented annually. Nicor creates an optimal storage plan that includes the daily, monthly, and seasonal activity that are needed to reach the seasonal inventory targets required to meet Nicor's operating objectives. Nicor further asserted that, while actual storage activity will vary on a daily basis from the base plan, due to weather and customer usage variations, Transportation customers' usage patterns, compared to the overall physical storage operating patterns, show that their activities are linked to other factors, such as economic drivers. Nicor Reply Brief at 84; Nicor Ex. 38.0 at 29-30.

iv. Analysis and Conclusions

We conclude that Nicor's proposed reductions to the MDN limitations for Transportation customers for the months of March and April and for the months of July through October must be rejected. Also, the alternative proposals, proffered by both Staff and CNE/Nicor, are hereby rejected. In Nicor's last rate case, we stated that:

> The record contains no analysis that demonstrates Transportation customers intentionally interfere with Nicor's efforts to cycle its storage fields or that the activities of Transportation customers have ever actually interfered with Nicor's efforts to cycle its storage fields. In the absence of additional empirical evidence or a more compelling argument, the Commission has no choice but to reject Nicor's proposal.

Nicor Rate Case Order at 131. The same could be said here.

Nicor contends that reductions to the MDN limitations are necessary because they will reduce the likelihood that it will have to impose pipeline caps. Yet, it is not contested that Nicor has actually not imposed such a cap in the last 16 months. Therefore, Mr. Bartlett's statement that Nicor has had to cap pipelines is inaccurate. Moreover, Mr. Bartlett's statement that unspecified personnel at Nicor "have heard" from unspecified personnel at pipeline suppliers that caps are disruptive to those suppliers does not aid Nicor. Mr. Bartlett made no attempt to state who made this statement or, to whom it was stated, or when it was stated.

From this statement, we cannot determine who said what to whom, there is no indication as to what pipeline supplier was involved in this statement, or, even what a "disruption" would entail. We also cannot determine when this statement was made, what context it was made in, or, if it was indeed, really stated. And, this statement allowed no opportunity for Staff or parties to cross-examine the person who uttered it. Mr. Bartlett's testimony as to the need for the reductions at issue here in order to reduce the possibility of imposing pipeline caps is, therefore, not persuasive. Nicor did not establish that a reduction in the MDNs will reduce the need for it to impose pipeline caps. It also did not establish that a need to impose pipeline caps is a likely possibility.

Additionally, there is no evidence that Nicor's ability to serve its Sales customers is harmed or compromised by the activity of its Transportation customers. It is not disputed that, despite the language in Nicor's last rate case Order, Nicor has presented no study demonstrating the impact of Transportation customers' use of their SBS on the cost of Sales customers' gas. What Nicor has presented, instead, is Nicor Ex. 19.3. However, as Staff and the IIEC have pointed out, this document is "problematic." And, there is no credible evidence aside from Nicor Ex. 19.3 that would indicate that the activities of Nicor's Transportation customers have an impact upon its Sales customers.

According to Mr. Bartlett's testimony, he prepared Nicor Ex. 19.3 to compare the estimated actual daily storage activity of Transportation customers to their proportionate share of the total planned daily storage activity of company-owned on-system storage fields. Nicor Ex. 19.3 analyzed the 12-month period from December of 2006 to

November of 2007. The daily proportionate share of storage was then compared to the Transportation customers' estimated actual daily storage activity. The difference between the two was then considered to be the volumetric impact on Sales customers. This volumetric impact was "valued at the difference between the cash price for Chicago and the settle (*sic.*) of the NYMEX futures contract for the prompt month for each day." Nicor Ex. 19.0 at 15.

The results of the analysis on that document, Mr. Bartlett averred, indicate that Sales customers are negatively impacted by Transportation customers' use of their on-system storage capacity. To the extent that Transportation customers' use their storage capacity differently than their proportionate share, Sales customers, according to Mr. Bartlett, must make up the difference. *Id.* at 16. Thus, Nicor Ex. 19.3 purports to determine the amount of gas that is needed to cover for Sales customers due to deviations from the storage plan caused by Transportation customers' activities. Tr. 199.

Nicor Ex. 19.3 compares Nicor's Storage System Plan with Transportation customers' allocated storage, their estimated on-storage activity versus "Potential Impact on Sales Customers," which is found, on that document, in two columns. One of those two columns is "GDD Price Exposure: GDD vs. NYMEX."[16] The other column is: "Daily Cost/Gain." Nicor Ex. 19.3. Therefore, this document appears to represent the financial gains/losses that Nicor's Sales customers experience when its Transportation customers' activities required it to buy gas.

However, nowhere in Mr. Bartlett's testimony does he actually state that the figures in the "GDD Price Exposure" column are based on actual transactions, or transactions that typically happen, or even that these transactions are likely to occur. *See, e.g.,* Nicor Exs. 38.0 at 29-30; 19.0 at 15-16. In fact for the 12-month period covered in Nicor Ex. 19.3, Nicor purchased no gas at the NYMEX futures contract price for the prompt month. Tr. 200-01. There is no evidence, therefore, that Nicor Ex. 19.3 represents an actual, or even likely, determination as to what Sales customers would experience as a result of Transportation customers' activities.

We further note that Nicor has asserted that the operational storage plan in Nicor Ex. 19.3 is a reasonable working plan that is implemented on an annual basis. We take no issue with the veracity of the column in Nicor Ex. 19.3 that represents Nicor's storage plan for the time period in question. Rather, we take issue with the lack of evidentiary foundation for the columns to the far right on that document, in so far as they purport to show the financial impact upon Sales customers of transactions which Nicor has not established, by laying a foundation, actually occurred or are representative of what could occur.

We note that Nicor, the parties and Staff have differentiated between Nicor's proposed MDN reductions for the months of March and April and those for July through October. Indeed, Nicor's proposed agreement with CNE is some indicia that Nicor is more willing to forego its proposed reductions to the MDNs for the months of July through October than it is for March and April.

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[16] "GDD" is the Chicago citygate price. Tr. 200.

However, even with regard to these two months, (March and April) Mr. Bartlett's testimony establishes that Nicor's storage fields are performing well. While Mr. Bartlett made vague statements regarding the possible problems that could occur, unless Transportation customers' MDNs are decreased, he did not state facts establishing that problems have occurred. He also did not state facts indicating that problems are even likely to occur, if Nicor's proposed MDN restrictions are not imposed. Moreover, as Staff has noted, there is no evidence establishing that Nicor's proposed MDN reductions are even appropriate. Nicor has given this Commission no evidence establishing that there is a "problem" that needs addressing by changing the MDN limitations.

Moreover, we note that Nicor agreed to Staff's alternative proposal, which is, that Nicor would impose the following conditions: (1) for the month of March, Nicor would change the injection rights afforded under its current proposal from 150% of a customer's historical March usage, to 200% of a customer's historical March usage; and (2) for the month of April, Nicor would change the injection rights afforded under its current proposal from 110% of a customer's historical April usage to 120% of a customer's historical April usage. Thus, Nicor agreed voluntarily to forego its proposed MDN reductions for the month of March. This is further indicia that Nicor would not suffer, if we declined to adopt Nicor's adopted reductions of Transportation customers' current MDN rights for the months of March and April.

As was the case in Nicor's last rate case, we conclude that Nicor has given us no specifics with regard to any harm, or, even any potential harm, to Sales customers on the part of Transportation customers. We also find that Mr. Bartlett's general statements regarding Nicor's cycling needs in March and April do not indicate that Nicor has experienced, or is even likely to experience, any harm, due to the current injection MDN levels for the months of March and April.

Generally, this Commission, as it is required to do, adheres to the Illinois Rules of Evidence. As was stated above, Nicor Ex. 19.3 lacked the basic evidentiary foundation, in many respects. We therefore did not consider it. We also conclude that, for the reasons stated above, Nicor, the entity with the burden of proof, did not proffer credible evidence establishing that the restrictions that it seeks to impose upon its Transportation customers' MDN limitations, for any month, are reasonable or needed. For the reasons stated above, the Commission concludes that no change to the existing restrictions on these customers' rights, is, in fact, warranted for the months of March, April, or, for the period of time from July through October.

2. Storage Calculations

There are three parameters related to the Storage Banking Service, or the SBS, that are at issue. They are the SBS Entitlement, the SBS Charge and the Storage Withdrawal Constant (the "SWC"). The SBS Entitlement is the storage service volume that can be subscribed to by each Transportation customer. The SBS Charge is the price paid for these services, and the SWC is employed to determine the gas quantity that Transportation customers can withdraw from their banks on a Critical Day. Currently, all three of these parameters are calculated using Nicor's non-coincident historical top gas capacity of 149.74 Bcf.[17] Nicor proposed to change the SBS provisions relating to the SBS Charge, the SBS Entitlement, and the Storage Withdrawal Constant in its' tariffs for Transportation customers, including Rates 74, 75, 76 and 77 and through Rider 25, Rates 4, 5, 6 and 7.

The SBS entitlement is the maximum amount of gas that any individual Transportation customer is allowed to maintain in its storage account with Nicor. This entitlement is articulated as so many times the customer's Maximum Daily Contract Quantity, (its "MDCQ") or, X days of storage. It is not contested by any party that this multiple of MDCQ should be established by dividing the maximum capacity of Nicor's storage fields (the numerator), by Nicor's design day sendout, which is Nicor's peak day sendout (the denominator). No party has disputed the veracity of Nicor's assertion that its peak day sendout is 49 million therms. However, there is a dispute concerning the numerator in this equation, which is, the maximum capacity of Nicor's storage fields.

Staff, CNE and IIEC recommend that the maximum capacity should be set at the amount that the Commission approved in Nicor's last case, which is 149.74 Bcf. Nicor asserted that this number should be reduced to 134.6 Bcf of storage.

a. Staff's Position

Staff recommended that all three SBS calculations (the SBS Entitlement, the SBS Charge and the Storage Withdrawal Constant) should be based upon 149.74 Bcf of storage, which is, Staff asserted, consistent with the Commission's decision in Nicor's last rate case. Staff argued that in Nicor's last rate case, Docket 04-0779, Nicor proposed to base all three of the parameters at issue on its "expected cycling." The Commission rejected this, stating:

> The Commission is convinced that the issue here is one of capacity allocation rather than some type of usage or volume allocation as Nicor's proposal could reasonably be characterized.… The Commission believes that the SBS entitlement charge, by its very nature, is a capacity charge, not a usage or volumetric charge.…It would be inappropriate to base this capacity charge on the volume of gas that Nicor expects to be drawn out of storage. Instead, the capacity charge should be based upon the entire capacity of working gas in storage.

Nicor Rate Case Order, at 120. Staff submitted that here, rather than refer to "expected cycling," Nicor based the three parameters on targeted working gas inventory. However, according to Staff, Nicor's basis for its changes to the three parameters is, once again, the volume of gas that Nicor expects will be used, which is the same thing as Nicor's expected cycling. Staff Initial Brief at 112-13.

Staff averred that Nicor's description of its working gas inventory evolved, in testimony, from the level of working gas inventory targeted for the on-system storage fields to the amount of "capacity" that is "usable." However, according to Staff, the

[17] The term"Bcf" is billion cubic feet. eia.doe.gov.

amount of capacity that is usable is the same thing as Nicor's expected cycling. Staff surmised that, although Nicor does not use the same terminology as that which it used in its last rate case, it uses the same concept. Staff concluded that therefore, the concerns that this Commission expressed in Nicor's last rate case regarding linking a capacity charge with actual usage, instead of capacity, still apply. Staff Initial Brief at 114.

Staff asserted that the amount proposed by Nicor, 134.6 Bcf, is not a capacity and it is not a maximum amount. Nicor's top gas inventory was 149.2 Bcf in 2001-2002. However, in only one year since 2001 has Nicor's top gas inventory been less than 134.6 Bcf. Staff concluded that therefore, 134.6 Bcf is only a "maximum amount" in relation to Nicor's storage plan, not an amount of capacity. According to Staff, 134.6 Bcf is the amount of "targeted" non-coincident top gas inventory that Nicor has planned for the test year. The only evidence that 134.6 Bcf is the correct amount upon which to base these calculations is provided in Nicor's plan, Nicor Ex 4.1. However, Nicor Ex. 4.1 only shows a targeted inventory for 2008-2009.

Staff also argued that Nicor provided this Commission with no basis for using "operationally available capacity" as a standard. This term is not an industry standard. Staff further argued that, if the Commission determines rights and charges based upon Nicor's targeted inventory, as opposed to the amount of capacity, nothing would prevent Nicor from arbitrarily changing its plans, and, therefore, changing its targeted inventory, as, a targeted inventory is entirely dependent upon the discretion of Nicor's personnel. Tr. 236; Staff Initial Brief at 115.

Staff further stated that, if the Commission alters its course from its previous finding that a capacity-based allocation must be used, and instead, bases SBS calculations on an amount that represents actual usage, the amount that should be used is the average of the maximum physical top gas inventories for Nicor's storage fields for the past four years, which is, 136.3 Bcf. *Id.* at 116-17.

b. The IIEC's Position

The IIEC recommended that the formula for determining the SBS entitlement, as approved by the Commission in Nicor's last rate case, should remain unmodified. It contended that the Commission should continue to require use of the maximum non-coincident capacity of Nicor's storage fields (149.74 Bcf) as the numerator in the formula for determining the SBS entitlement.

The IIEC submitted that what the Commission approved in Nicor's last rate case was use of the non-coincident peak capacity of each of Nicor's eight storage fields, that is, the sum of the maximum demonstrated capacity of each of those fields. It argued that no party claims that the non-coincident maximum capacity of Nicor's storage fields has diminished since the time of Nicor's last rate case. Also, Nicor has confirmed that its storage fields have not suffered any degradation in performance or capacity since its last rate case. The IIEC averred that, notwithstanding that Nicor never explicitly proposed to change the formula approved by the Commission in Docket 04-0779, in effect, Nicor is proposing to make a *de facto* change to the formula by coining a new term, which is, "operationally available capacity," in the amount of 134.6 Bcf. IIEC Initial Brief at 22, *citing* Tr. at 211-14.

The IIEC additionally asserted that use of 134.6 Bcf is not fair to Transportation customers. Transportation customers have never "operationally" achieved the theoretical maximum amount of storage that they select. Even if it were pragmatically possible for a single Transportation customer to achieve its absolute maximum entitlement, the only way that the Transportation customers, as a class, could achieve that maximum would be for every single one of the thousands of Transportation customers on Nicor's system to achieve their maximum allowable storage balances on the same day. The IIEC further asserted that while Nicor has portrayed its proposed change as one that is needed because it cannot cycle the full 149.7 Bcf, in fact, there is no study in the record that would demonstrate that this is true. IIEC Reply Brief at 23; *see also,* Tr. 173-175.

c. Nicor's Position

Nicor proffered that, when developing the SBS Entitlement, the Commission should use 134.6 Bcf as the appropriate capacity level, which is, the maximum amount of storage capacity that is operationally available. 134.6 Bcf, therefore, represents the maximum amount that Sales, Transportation and Customer Select customers can use. Nicor Ex. 48.0 at 40, 43. It further contended that it would be inappropriate to continue to use the 149.7 Bcf capacity figure because that amount of capacity is not operationally available. Since the 2004 Rate Case, the total maximum non-coincident level of available working gas in storage from 2005 to 2007 was 138.9 Bcf, 135.0 Bcf, and 134.1 Bcf, respectively. Nicor Initial Brief at 86.

d. CNE's Position

According to CNE, the central issue relative to all of the three storage calculation issues is the level of on-system storage capacity to use, as the on-system storage capacity input is plugged into the formulas for calculating all three figures. It noted that Nicor is the only party that recommended revising the value for on-system storage capacity in these formulas to an inventory-based metric. CNE argued that Nicor's proposed 134.6 Bcf is not a capacity amount at all. Staff, the IIEC and CNE agree that the amount asserted by Nicor, 134.6 Bcf, is a "targeted" non-coincidental inventory figure that is not based on storage capacity. However, CNE admitted that there has been no change in the integrity of the storage fields. CNE Exhibit 3.2; CNE Initial Brief at 10.

CNE continues to believe in the merits of the above arguments. However, in order to reach some commercial certainty, it entered into the settlement with Nicor addressing the issue of SBS calculations. Pursuant to that settlement, Nicor and CNE have agreed to jointly recommend the Commission adopt a storage capacity value in the SBS calculations of 142.37 Bcf. The evidentiary basis in this proceeding in support of this recommendation is found in CNE Exhibit 1.4, which provides the four-year, non-coincident peak of Nicor's working gas in its storage fields from 2004 through 2007, resulting in the 142.37 Bcf figure. *Id.* at 10-11.[18]

CNE maintained, however, that this Commission should reject Staff's proffered alternative, as, according to CNE, Staff's alternative suffers from the same infirmities as those that exist in Nicor's proposal. Staff suggested using an average for the maximum physical top gas inventories for Nicor's fields for the past four years, which is 136.3 Bcf. However, CNE continued, as Staff has noted, adoption of this alternative requires the Commission to reject the use of capacity in SBS calculations, and rely only upon actual usage, which the Commission rejected in Nicor's last rate case. CNE averred that Staff's proposed alternative is not based on capacity; instead, it is a measure of historical volumetric inventory during a four-year period. Also, it is not supported with any studies or analysis to support it as the appropriate measure of storage. CNE further argued that Staff's proposed alterative is not supported in the record with any studies or analysis to determine the impact on Transportation Customers of using a lower Bcf as a measure of storage capacity. CNE Reply Brief at 11-12.

e. Analysis and Conclusions

We decline to accept any of the proposed changes to the amount of SBS capacity that was determined in Nicor's last rate case, which is 149.74 Bcf of storage. There are no studies to indicate that the maximum capacity of Nicor's storage fields has changed. As this Commission concluded in Nicor's last rate case, Docket 04-0779, Nicor's storage *capacity* is at issue here, not its' cycling plan. While we can appreciate that, over time, the amount of storage capacity in an aquifer storage field could diminish, there is no evidence here that in fact, any of Nicor's storage has, in fact, degraded. The amount of storage capacity is, therefore, the same, regardless of how much, or how little, is actually stored therein. Yet, Nicor's proposal is based upon how much is stored, not how much can be stored.

Nicor's argument that the SBS calculations should be determined using 134.6 Bcf of storage, instead of 149.74 Bcf, is premised on use of "operational capacity" or, "expected cycling" or, what is "operationally available." These terms, and indeed, the evidence Nicor presented, all refer to use of Nicor's cycling plan, or, its targeted inventory, as a basis for determining SBS capacity, not its actual capacity. Nicor's planned operational capacity, or, its' expected cycling, is what Nicor expects to be drawn out of storage, the very thing that this Commission determined, in Nicor's last rate case, should *not* be used. Nicor Rate Case Order at 120. Additionally, there are no studies or independent evaluations to support Nicor's assertion that what it calculates to be "operationally available" represents the amount of capacity.

[18] However, this agreement is contingent upon the Commission's acceptance of the MDN amount that was proffered by CNE and Nicor. Nicor Reply Brief at 87. As we did not accept the MDN amount proffered by CNE and Nicor, (*See,* Section IX(C) herein) we need not entertain CNE's proffered SBS value of 142.37 Bcf.

While the name of the term Nicor uses to support its conclusion may have changed, Nicor is again asserting the same argument as that which it asserted in its last rate case. This argument was rejected in Nicor's last rate case and Nicor provides us with no facts indicating that facts or circumstances have changed since that time. It also has not indicated why this Commission's previous decision was incorrect. We caution the parties to refrain from continuing to assert unsuccessful arguments without providing an explanation as to a change of circumstance, or, an explanation as to why the Commission's previous decision was incorrect.

We conclude that there is no evidence that the amount of Nicor's storage capacity has changed since the time the Order issued in Nicor's last rate case. What evidently has changed, however, is Nicor's cycling plan, which is not the same as how much storage Nicor has. And, as Staff points out, what Nicor plans is entirely subjective, in that, nothing prevents Nicor from changing its plans, and, therefore, changing its targeted inventory. Nicor's proposed change to the SBS Entitlement is therefore, rejected.

3. Storage Banking Service ("SBS") Entitlement

Nicor proposed to retain the amount of 28 days of MDCQ (Maximum Daily Contract Quantity) of storage for transportation customers. This amount was determined in Nicor's last rate case. Staff and the IIEC contended that the SBS entitlement should be increased to 31 days.

a. Staff's Position

Staff recommended that the SBS entitlement be increased from 28 to 31 days. Staff argued that this increase results from the decrease in peak design day from 5.28 Bcf to 4.9 Bcf. Staff averred that the methodology for determining the SBS entitlement that Staff, the IIEC and CNE support, is the one approved by the Commission in Nicor's last rate case. That method is to divide the historic non-coincident top gas capacity by the peak design day. Because the peak design day has fallen, application of the method set forth in Nicor's last rate case raises the number of MDCQ of storage from 28 to 31 days. Staff Initial Brief at 117-18; Staff Ex. 24.0R2 at 23.

The peak day has fallen from 5.3 Bcf (approximately) to 4.9 Bcf. Because the storage fields' capacity is constant, there now is a higher allocation of peak days for all customers, including Transportation customers, resulting in an increased entitlement of 31 days. With a peak design day of 4.9 Bcf, the maximum capacity that can be delivered is 149.74 Bcf divided by 4.9 Bcf, or, 31 days. Staff Ex. 24.0R2 at 22-23.

Staff pointed out that Nicor has not argued that the method of allocation is unfair. Nicor also has not recommended changing use the of the peak days of deliverability as the allocator. Staff Initial Brief at 117.

b. The IIEC's Position

The IIEC averred that Nicor's design day demand for gas, which is now 4.9 Bcf, has decreased since the time when this Commission entertained Nicor's last rate case. It concluded that therefore, use of the Commission-approved formula set forth in Nicor's last rate case would produce an entitlement of 31 days, instead of the 28 days determined by Nicor. IIEC Ex. 2.0 at 32-34.

c. Nicor's Position

Nicor contended that the Commission should approve its proposed 28-day SBS Entitlement. Nicor's calculation of the SBS Entitlement is the equal number of peak days of on-system storage capacity that is available to all of Nicor's customers. Nicor divided 134.6 Bcf of storage capacity by 4.9 Bcf of peak day deliveries for the 2009 test year, which resulted in 27.5 peak days of capacity, which was then rounded to 28 days. Nicor Initial Brief at 85-86.

In its Reply Brief, Nicor asserted that, based upon post-hearing discussions with CNE, Nicor and CNE agree that the SBS entitlement would be based on an assumed available on-system capacity of 142.37 Bcf. It averred that therefore, the Commission should approve an SBS Entitlement based on an assumed available on-system capacity of 142.37 Bcf. Based upon the agreement between Nicor and CNE, Nicor contended that the SBS Entitlement should be set at 29 days. CNE Initial Brief at 29; Nicor Reply Brief at 88.[19]

d. Analysis and Conclusions

No party has contended that use of 4.9 Bcf as the peak design day is incorrect. The only difference between what Nicor proffers and what Staff and the IIEC have recommended is whether to use 149.74 Bcf in the calculation at issue as the maximum capacity of Nicor's storage fields. This issue was addressed and resolved in Section IX(C)(2)(a) herein. For the reasons stated therein, we conclude that 149.74 Bcf is the correct amount to be used when calculating the amount of SBS entitlement. When 149.74 is divided by 4.9, the result is 30.55 days. The result, when rounded up, is 31 days. Nicor's proposed change is therefore rejected.

4. The Storage Banking Service ('SBS") Charge

Nicor proposed to change its proposed SBS charge of $.0042 per therm of storage capacity. Calculation of this charge, is based in part upon use of 134.6 Bcf as the maximum capacity of its storage fields. Staff and the IIEC contended that this charge should be determined based upon 149.74 Bcf of storage as the maximum capacity of Nicor's storage fields, which reduces this charge to $.0038 per therm.

[19] As was stated previously herein, Staff and the IIEC are not parties to this agreement.

a. Nicor's Position

Nicor proposed to update its SBS charge to reflect the current cost of servicing Transportation customers, which are Rates 74, 75, 76 and 77. It averred that the SBS charge should be determined by dividing the storage revenue requirement, excluding top gas and storage gas losses, by the amount of storage capacity that is operationally available, 134.6 Bcf of storage, which is then divided by 12, to compute the monthly cost per therm of capacity charge. Nicor Initial Brief at 87-88.

b. Staff's Position

Staff asserted that in Nicor's previous rate case, the Commission determined that the SBS charge should reflect capacity, instead of Nicor's expected cycling, because this charge is collected from SBS customers based on the amount of capacity that customers subscribe to, not the amount of inventory they use. Staff recommended that the SBS charge should be increased from the existing $.0029 per therm to $.0038 per therm of SBS capacity subscribed. Staff Initial Brief at 118-119.

c. The IIEC's Position

The IIEC averred that here, Nicor proposes to increase the SBS charge in this case from 0.29 cents to 0.42 cents per therm per month, which is, an increase of 45%. The IIEC took exception to the denominator Nicor used in the formula (storage cost divided by storage field capacity) to calculate the SBS charge. As was the case with the issue of the correct denominator to use in the calculation of the SBS Entitlement, the IIEC asserted, that the Commission should reject the use of the amount of "operationally available" gas that Nicor claims, and instead retain the notion of using the maximum non-coincident capacity of the fields which has been demonstrated to be 149.7 BcF and which is fully consistent with the 04-0779 Order. IIEC Initial Brief at 24-26.

d. Analysis and Conclusion

As was the situation in subsections IX(C)(2)(a) and (b) herein, the issue here is whether to use 134.6 Bcf or 149.74 Bcf in the calculation of the charge at issue. No party has contended that any other portion of Nicor's calculations are incorrect. No party has contended that the figures that 149.74 and 134.6 Bcf represent should not be used. The sole issue is whether 134.6 Bcf of storage represents Nicor's maximum storage field capacity or, whether 149.74 Bcf of storage represents that amount This issue was fully resolved in subsection IX(C)(2)(a) herein. The correct amount, as was stated therein, is 149.74 Bcf of storage. Therefore, using 149.74 Bcf to calculate the SBS Charge yields $.0038 per therm. Nicor's proposed change is therefore, rejected.

5. The Storage Withdrawal Factor

Nicor's Transportation customers receive a Storage Withdrawal Factor, (an "SWF") which is expressed as a numerical value that is not to exceed 1.0. The SWF measures the extent to which customers have been successful in filling their storage to at least 90%. The SWF is reduced proportionately for storage levels that do not reach

90% of the customer's capacity. 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 that can be withdrawn from Nicor Gas' storage field on a Critical Day. Nicor Initial Brief at 88.

6. The Storage Withdrawal Constant

a. Nicor's Position

Nicor proposed to increase the Storage Withdrawal Constant (its "SWC") from .017 to .0182. It calculated the Storage Withdrawal Constant by dividing the proportion of deliveries it can withdraw from storage on a peak day by the number of SBS Entitlement days granted by the Commission to Transportation customers in this proceeding. Mr. Mudra's testimony establishes that the primary disagreement amongst the parties is whether to use 134.6 Bcf or 149.7 Bcf as the number that represents Nicor's storage capacity. He testified that, using 149.7 Bcf in the calculation yields .0165 as the storage withdrawal constant (2.5 Bcf divided by 149.7 Bcf). Nicor Ex. 48.0 at 51-52.

b. Staff's Position

Staff recommended that the SWC remain at 0.017. Staff asserted that, when calculating the Storage Withdrawal Constant, Nicor used the "operationally available capacity" of 134.6 Bcf. Also, because Nicor's witness used two different methods of calculating the Storage Withdrawal Constant, Staff averred, that the method that should be used is the one that uses the amount of storage capacity in the calculation. (149.74 Bcf). Staff also noted that Mr. Bartlett testified that the same value should be used in all of the pertinent calculations. Staff Initial Brief at 120, citing Nicor Ex. 38.0 at 20-21.

c. Analysis and Conclusions

The issue here is how to calculate the Storage withdrawal Constant, as, Nicor's witness Mr. Mudra provided calculations using both 134.6 Bcf and 149.7 Bcf in his equations. He also provided two methods to calculate the Storage Withdrawal Constant. We agree with Staff that, in the future, when calculating the Storage Withdrawal Constant, Nicor should employ the calculation method that uses the amount of available storage capacity, which is, the set of calculations in Mr. Mudra's surrebuttal testimony that responds to Ms. Fabrizius, (Nicor Ex. 48.0 at 51-52) or, 2.5 Bcf divided by 149.74 Bcf. As the Commission previously determined in Section IX(C)(2)(a) herein that 149.74 Bcf is the amount that represents the amount of storage capacity. Therefore, using 149.74 in the calculation yields a Storage Withdrawal Constant (2.5 Bcf divided by 149.74 Bcf) of 0.0166. When rounded up, this figure becomes 0.017. This, amount, therefore, is the amount of the Storage Withdrawal Constant that we approve.

7. Timing of the Storage Withdrawal Multiple Calculation

The Storage Withdrawal Factor reduces a Transportation customer's ability to withdraw from storage to the extent that it has not filled its storage capacity. The

Storage Withdrawal Factor is a multiplicative adjustment to a customer's withdrawal limitation. It is a Transportation customer's November 1st inventory balance divided by 90% of that customer's SBS capacity. IIEC Ex. 1.0 at 21.

Currently, Nicor determines a customer's Storage Withdrawal Factor on November 1st. The IIEC proposed that the Commission should require Nicor to make this determination between October 15th and November 15, as opposed to this determination being made exactly on November 1st.

a. Nicor's Position

Nicor opposed the IIEC's recommendation to require it to make this determination between October 15th and November 15, as opposed to the having this determination being made exactly on November 1st. Nicor bills its Transportation customers at the end of the month. It therefore has all the information needed to calculate the Storage Withdrawal Factor on October 31st, but not at any other point in time between October 15th and November 15th. Thus, according to Nicor, expanding the evaluation period would complicate the calculation process and result in no meaningful improvement.

Additionally, Nicor is required by tariff to notify its daily-balanced customers shortly after November 1st of their new Storage Withdrawal Factor. This is important, Nicor asserted, because a Critical Day can be called on or after November 1st of each year and a customer's Storage Withdrawal Factor can be utilized as early as November 1st. A November 15th deadline would push back the process of notifying customers of their Storage Withdrawal Factor by at least another two weeks, which is well-past the time when a Critical Day can be called. Nicor Initial Brief at 90.

b. Staff's Position

According to Staff, a one-day target provides the best approach. Trading stored gas with a 30-day window, as was proposed by the IIEC, would simply not work. Staff recommended that the Commission order Nicor to continue to calculate the Storage Withdrawal Factor on November 1st. While Staff is sympathetic with the IIEC's point, which is, there is a lack of parity between Nicor and Transportation customers, in Staff's opinion, the IIEC advanced no practical response that would enable Nicor to calculate maximum values between billing periods and meter readings. Because Nicor does not have accurate SBS inventory data on a daily basis between billing periods, Staff opposed the IIEC's proposal. Staff Initial Brief at 121.

Staff averred that its proposal to allow balance trading (*See,* Section (IX)(C)(5) of Staff's Briefs) will help users achieve the 90% target on November 1st because it allows Transportation customers with balances below 90% to purchase gas from those customers that have balances that are above 90%. These transfers will not negatively affect Nicor, Staff maintained, because Transportation customers, as a group, will still be above the 90% target. *Id.*

Staff also objected to the IIEC's proposed 30-day compliance window 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 permit these suppliers to rise above the 90% target, only to reduce their supplies. Also, under this proposal, nothing would prevent individual customers from "hitting" the 90% target early, *e.g.,* on October 15th, and then withdrawing to below that target before November 1st, thus depriving Nicor of that gas for later in the year. Staff argued that the IIEC's proposal would create perverse consequences that would lead to circumvention of the fall injection target, when it is combined with trading of stored gas. Staff Reply Brief at 48-49.

c. CNE's Position

CNE supported the IIEC's proposal to provide Transportations customers with a window between October 15th and November 15. CNE averred that, between leased storage assets and its own fields, more than 90% of Nicor's storage has the level of flexibility that the IIEC requested. CNE Initial Brief at 34-35.

d. The IIEC's Position

The IIEC proposed that the Terms and Conditions provisions in Nicor's tariffs should be modified so as to establish the Storage Withdrawal Factor based on a customer's maximum storage inventory during the period of time between October 15 and November 15 of each year. Currently, these tariffs provide that the Storage Withdrawal Factor is based solely on a Transportation customer's inventory as it exists on November 1st. The IIEC's witness Dr. Rosenberg made this proposal to relax the effect of the requirement that customers reach their absolute maximum capacity precisely on November 30, or be subject to a diminished withdrawal capability. IIEC Ex. 1.0 at 22.

It contended that, in recent years, Nicor's individual storage fields have achieved their maximum inventory from as early as October 22nd to as late as December 13th. Nicor has daily meter readings for all of Rate 76 and 77 customers. It averred that therefore, it would be a simple matter to restrict Dr. Rosenberg's proposal to only daily-metered customers. Additionally, if a Critical Day were to be called between November 1st and November 15th, Nicor could utilize the Storage Withdrawal Factor based upon the previous year's maximum storage. IIEC Initial Brief at 27-28.

The IIEC acknowledged that Staff proposes to modify this storage balance trading proposal to make it applicable to larger Transportation customers, but, a final Commission determination is not certain. It averred that, if the trading service does not apply to large Transportation customers, its proposal to have the Storage Withdrawal Factor for daily-metered customers calculated between October 15th and November 15th should be adopted. IIEC Reply Brief at 25-26.

The IIEC also asserted that offering Transportation customers the right to trade storage imbalances does not necessarily provide them with the flexibility they may need. Even if Staff's proposal is adopted by the Commission, the IIEC maintained that this Commission should still adopt its proposal for determining the Storage Withdrawal Factor, for daily meter Transportation customers, between October 15th and November 15th. *Id.*

e. Analysis and Conclusions

We decline to adopt the alteration proposed by the IIEC. We note at the outset that the IIEC does not really state what its proposal would entail. It is not clear whether this approach would involve an average of a Transportation customer's gas for the 30-day period, or, just a random sampling during that time period. Possibly, yet another method of determining a Transportation customer's Storage Withdrawal Factor during this 30-day time period could have been contemplated, but not articulated.

Also, Nicor has additionally expressed legitimate concerns regarding its ability to calculate the Storage Withdrawal Factor. The IIEC has not set forth a practical way for Nicor to determine the Storage Withdrawal Factor, other than at the end of a billing period. November 1st is at the end of a billing period. While some Transportation customers appear to be daily-metered, it appears that not all of the affected Transportation customers have such meters. Moreover, there is no evidence indicating that using the Storage Withdrawal Factor based upon the previous year's maximum storage when a Critical Day is called is practical or wise.

Additionally, Staff articulated a legitimate concern, which is, that when combined with balance trading (*See,* Section IX(C)(4) herein) the IIEC's proposal could produce a situation whereby certain Transportation customers could circumvent the 90% requirement by passing a storage balance from one customer to another during the 30-day period, thus, depriving Nicor of that gas later in the year. We finally note that Staff's proposal regarding balance trading, (*See,* Section IX(C)(4) herein) will ease the effect of the Storage Withdrawal Factor upon Transportation customers.

8. Costs Associated with Storage and System Losses

a. The Storage Loss ("SLA") Factor

Nicor proposed to include $15.2 million of storage gas loss expense in its base rates. It used a loss adjustment factor of 2% of total gross storage field withdrawals to determine the quantity of gas lost in the operation of its storage fields. Nicor's 2% Storage Gas Loss factor is a subsection of its system-wide Unaccounted-For Gas Adjustment. It specifically relates to gas losses associated with Nicor's storage operations. Nicor Initial Brief at 90.

No party opposed including $15.2 million of storage losses in base rates in this proceeding. However, Staff proposed that the Commission should order Nicor to review its treatment of the allocation and recovery of the system and storage losses. Nicor did not object to Staff's proposal.

i. Staff's Position

Staff witness Mr. Anderson raised questions regarding the amount of losses calculated, and Staff witness Ms. Hathhorn objected to Nicor's accounting procedures. Staff witness Mr. Sackett reviewed Nicor's allocation and recovery methods and he concluded that there are problems with both. He objected to the methodology for allocating storage losses to Sales customers. Mr. Sackett recommended that Nicor recover its storage losses through the Unaccounted For Gas Adjustment ("UFGA") from its Hub customers, as well as its Transportation customers. Staff Ex. 11.0R at 24-26.

Staff recommended that the Commission direct Nicor to review its treatment of the allocation and recovery of the 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, which Staff addressed in Section XVI(A) of both of its Briefs, entitled, "Accounting for Storage Gas Losses." Staff asserted that Nicor 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 Initial Brief at 122.

ii. Nicor's Position

Nicor agreed to all of the accounting procedures recommended by Staff with respect to storage gas losses. It stated that it has a plan for transitioning from the current approach to a revised approach, which will be implemented prospectively. Nicor Initial Brief at 133-34.

iii. Analysis and Conclusions

Staff's recommendation to direct Nicor to review its treatment of the allocation and recovery of the system and storage losses, at the same time that it is reviewing its methodology for calculation the amount of storages losses, and the procedures for accounting for these losses, (*See,* Section XVI(A) herein) is reasonable and it is adopted. Nicor is directed to consult with Staff in this regard, and, if warranted, it must revise its accounting treatment of the allocation and recovery of these losses.

We further note that no party has objected to Nicor's inclusion of $15.2 million of storage losses in base rates in this proceeding. It is therefore approved.

9. Unaccounted-For Gas Adjustment ("UFGA")

a. Staff's Position

Staff witness Mr. Sackett reviewed Nicor's allocation and recovery methods for both storage and system losses and concluded that there are problems with both. He objected to the methodology that excludes Nicor's Hub customers from any direct collection of the cost of either storage losses or system losses. Mr. Sackett recommended that both storage and system losses should be recovered from Nicor's Hub customers, as well as its Transportation customers, through the Unaccounted-for Gas Adjustment. Staff Ex. Ex. 24.0 at 33-34.

Staff did not object to Nicor's current assessment of its Unaccounted-For Gas Adjustment. However, Staff recommended that the Commission order that, during Nicor's review of the methodology for calculating the amount of storage losses and the procedures for accounting for these losses, (*See* Section XVI(A) herein entitled "Accounting for Storage Gas Losses") Nicor review its procedures with Staff and, if warranted, revise its treatment of the allocation and recovery of both storage and system losses through the UFGA. Staff Initial Brief at 123.

b. Nicor's Position

Nicor asserted that unaccounted for gas, of which storage gas losses are a component, is recovered in-kind from Transportation customers. It is assessed based upon Transportations customers' deliveries to the Company's city gate. Unaccounted for gas is recovered in two different fashions from Sales customers: (1) effective with the 2004 Rate Case, unaccounted for gas attributable to Storage Gas Losses (2%) is recovered through base rates and included in Account 823; and (2) all other unaccounted for gas attributable to Sales customers is recovered through Rider 6 (Gas Supply Costs). Nicor ensures that customers served under its traditional Transportation Rates 74, 75, 76 and 77 are not charged for the Sales customers' portion of Storage Gas Losses. Nicor Initial Brief at 90-91.

Nicor contended that Staff's recommendation should be rejected. According to Nicor, Staff failed to demonstrate a clear nexus between its UFGA regarding Hub activity and the prospective development of accounting procedures for the SLA factor. Additionally, according to Nicor, it has fully explained how its UFGA is assessed to Hub volumes. Nicor has also explained how most of its Hub services are provided under tariffs approved by the Federal Energy Regulatory Commission and, therefore, are beyond the authority of this Commission. Nicor Reply Brief at 91.

c. Analysis and Conclusions

Nicor avers that most of its Hub services are provided pursuant to FERC tariffs, and, are, therefore, outside this Commission's jurisdiction. However, Mr. Sackett testified, that Nicor's Hub customers are not being allocated the proper amount of the unaccounted for gas adjustment. In essence, they are not "paying their fair share" of storage and system losses. The other customers, over whom we do have jurisdiction, therefore, are "paying more than their fair share" of the unaccounted for gas adjustment. Nicor proffers no law requiring this Commission to ignore Hub customers when considering the overall allocation of system losses regarding the customers, over whom, we do have jurisdiction.

We additionally note that Staff's recommendation here is modest, as it only operates prospectively. Nicor has provided this Commission with no reason not to adopt Staff's recommendation. Staff's recommendation is reasonable and it is hereby approved. During Nicor's review of the methodology for calculating its UFGA, Nicor shall consult with Staff and, if warranted, revise its treatment of the allocation and recovery of both storage and system losses through its unaccounted for gas adjustment (its "UFGA").

10. Intra-day Nominations

Originally, CNE recommended that the Commission approve a modified version of Nicor's alternative proposal to establish a modified evening nomination cycle, with a deadline of 3:00 p.m. on the business day before the start of the gas day. CNE proposed that the modified evening nomination cycle should also allow corrections of any mismatched timely cycle nominations. CNE Initial Brief at 6-7.

However, in the interest of compromise, Nicor stated in its surrebuttal testimony that it would be willing to pursue a pilot program with certain parameters, if the Commission deems it necessary for Nicor to offer some type of late or intraday service. Nicor Ex. 38.0 at 43. CNE agreed to Nicor's alternative proposal subject to certain modifications, which are set forth below.

a. The Position of CNE/Nicor

Based upon post-hearing discussions, CNE and Nicor agreed to resolve this issue as follows: Nicor will implement its proposed alternative intraday nomination process, as was summarized in Nicor Ex. 38.0, lines 962-78, in which it will add an additional late nomination cycle (a modified Evening cycle) with a deadline of 3:00 p.m. on the business day before the start that would be capped, according to Nicor's capacity availability. In addition, Nicor agreed that such modified Evening Cycle nomination: (1) is offered on a firm basis to the extent the volume is within the 1:00 p.m. posted availability for that date; (2) is available to all of Nicor's Transportation customers; and, (3) includes, at a minimum, an additional 20,000 MMBtu on a daily basis over and above the volume of timely cycle nominations. Further, Nicor will enter into collaborative sessions with interested entities to work on the resolution of nomination errors that occur solely due to an incorrect pipeline designation (*e.g.,* when there are no changes in the volume or scheduling of the nomination, but gas flow is actually on a different pipeline than the one designated upon submission of the nomination in the timely cycle) and report back to the Commission.

Both CNE and Nicor recommend approving the pilot program, the terms of which are set forth above.

b. Staff's Position

Staff continued to recommend that the Commission order Nicor to commence a pilot program to provide evening nominations and intraday nominations on a "best-efforts" basis. Staff recommended that this Commission order Nicor to implement a pilot program to provide the evening nomination (6:00 p.m.) on a firm basis and the intra-day nomination (10:00 a.m.) on a best-efforts basis. Staff Reply Brief at 91-92.

c. Analysis and Conclusions

Based on the information provided by Staff, CNE and Nicor, we conclude that it is necessary for Nicor to provide a late, or intraday, service. However, Staff has not set forth any reason establishing that its proposal is superior to that proffered by Nicor/CNE.

Therefore, we decline to conclude that Staff's proposal is the one that should be accepted. And, we conclude that the proposal proffered by CNE/Nicor should be approved.

CNE and Nicor have requested that this program be approved as a pilot program. Therefore, it should have some duration. We conclude that the duration of this pilot program should be four years, as is the case with various riders that Nicor proposes which instigate pilot programs. We further conclude that Nicor shall file a report with the manager of this Commission's Energy Division setting forth the results of its collaborative sessions with interested entities regarding resolution of nomination errors that occur due to incorrect pipeline designations, and setting forth the general activities pursuant to this pilot program that have occurred. This report shall be filed within 12 months after the date of this Order.

11. Trading of Stored Gas

Nicor currently allows a Transportation customer to trade its balance when one of its customers is in an excess storage position, which is when a customer has more gas in storage than its allowable storage capacity. This process allows the customer with excess gas to avoid paying an excess storage balance penalty, which is, $0.10 per therm. Nicor Ex. 48.0 at 54.

Staff proposed that balance-trading should be increased to allow Transportation customers to trade their inventories, even when one of the customers that is a party to the trade is not over-filled. At trial, Nicor entered into an agreement with Vanguard, whereby, it allowed the smaller, Rider 25 customers, to trade their balances, even when one of the parties to the trade is not over-filled, on a one-time basis per year. Staff argued that the right Nicor afforded to Vanguard should be afforded to all Transportation customers without the one-time per year limitation.

a. Staff's Position

Originally, Vanguard proposed that Nicor provide an expansion of its imbalance trades which would allow its Transportation customers to trade their inventories, even when their banks are not over-filled. Vanguard proposed that these trades should be offered in a manner that is identical to that which Peoples Gas and North Shore Gas currently offer. Specifically, these trades would be subjected to several limitations: trades must originate and remain on-system; trades cannot result in bank inventories below zero for the originator or above maximum capacity for the recipient, trades must be confirmed by both parties; trades may not eliminate penalties related to imbalances; and, trades must be subject to the timeframes that are currently imposed by the utility. *See,* Vanguard Ex. 1.0 at 3-5. Also originally, Nicor objected to Vanguard's recommendation. *See,* Nicor Ex. 29.0 at 31-32. Staff pointed out that Nicor did not state that it cannot provide the service. Nicor also did not contend that providing this service would degrade its ability to serve its other customers, or, that stored gas trades would harm its other customers.

At trial, however, Vanguard and Nicor reached an agreement to offer a one-time benefit only to customers on Rate 25. *See,* Staff Initial Brief at 125; Nicor Cross Exhibit

No. 5, "Rider 25, Firm Transportation Service, 5th Revised Sheet No. 78," Tr. 629-30. While Vanguard stated that all of its concerns have been met in the agreement, Staff does not agree with the solution that was reached. Staff contended that this agreement unduly restricts balance trading to one-time per customer per year. It is also only available to smaller customers that are on Rider 25. Staff argued that, if Nicor can provide this service for smaller customers, there is nothing in the record to support the exclusion of larger Transportation customers from this service. Staff pointed out that the Commission has already approved this same concept in the Peoples Gas rate case, citing the Peoples Gas Rate Case Order, Docket 07-240, at 271-272. Staff Initial Brief at 125.

Staff supported imposing the original concept in Vanguard's initial proposal described above because it allows Transportation customers to trade balances and, in so doing, it offers greater flexibility to all Transportation customers without unduly degrading service for Nicor's Sales customers or placing reliability at risk. Staff Ex. 24.0 at 36-37.

In Staff's view, the fact that limited availability of stored gas trading meets the needs of one Intervenor, Vanguard, does not legitimize making these trades unavailable to the majority of Transportation customers that are served by rates other than those pursuant to Rider 25. Staff recommended 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 Reply Brief at 53.

Staff additionally argued that Nicor is proposing to increase the Excess Storage Balance Transfer fee from $15 to $24, which is a 60% increase. However, Nicor did not list this proposed change with the other changes to Transportation customers' charges. Also, there is no justification for this increase in the record. Staff concluded that therefore, Nicor has not met its burden of proof to support this increase. Staff additionally noted that, under Nicor's current tariffs, this charge is already three times higher than the $5 charge approved by the Commission for Peoples Gas. Staff recommended that the Commission reject this increase and instead keep the charge at $15 per trade. Staff Initial Brief at 125-26.

b. Nicor's Position

Nicor maintained that this Commission should reject Staff's proposal in light of the agreement reached by Nicor and Vanguard. Vanguard and Nicor engaged in discussions after the filing of testimony, which resulted in Nicor proposing revised language for Rider 25 that addressed Vanguard's concerns. Due to the revised Rider 25, Vanguard withdrew its proposal regarding storage balances trading for purposes of this proceeding. Tr. 629. Nicor argued that Staff is rejecting the negotiated agreement between itself and Vanguard. Given that Vanguard operates in the market, Nicor argued that this Commission should give weight to this agreement. Nicor also submitted that there is no evidence to support Staff's argument that balance trading will help Transportation customers achieve the 90% target on November 1st. Nicor Reply Brief at 92-93.

c. Analysis and Conclusions

Nicor did not address Staff's contention that the Excess Storage Balance Transfer fee should not be increased. Nicor has, therefore, waived its right to contend that this increase should be imposed. We therefore conclude that it shall not be imposed.

We disagree with Nicor's contention that Staff has "rejected" a negotiated agreement. Staff has concluded that Nicor should be required to proffer the service that is the subject of that agreement to all Transportation customers, and, that Nicor should be required to offer that service more often that what Nicor has offered to provide in that agreement. Nicor has presented no evidence establishing that adopting Staff's proposal is not feasible, or, that it is harmful to Nicor, or that it is harmful to Nicor's other customers. The fact that Nicor voluntarily decided to offer this service, albeit only once per year, to Rider 25 customers, is some indicia that Staff's balance trading proposal is feasible and is not harmful to Nicor or to its other customers. The fact that Peoples Gas offers such a service is further indicia that Staff's proposal is feasible and is not harmful.

We further disagree with Nicor's assertion that the evidence does not support a conclusion that that Staff's proposal to allow balance trading will help Transportation customers achieve the 90% target on November 1st. Clearly, Staff's proposal increases Transportation customers' flexibility. An increase in flexibility helps ensure that these customers can achieve the 90% target.

For the reasons stated herein, Staff's proposal is hereby adopted. Nicor shall revise the pertinent tariffs accordingly.

12. Super-pooling on Critical Days

CNE and Nicor entered into an agreement whereby Nicor agreed to two proposals that would eliminate, or mitigate, the financial penalties that a Rider 13 Transportation customer incurs when Nicor calls a Critical Day. Staff, however, asserted that this agreement does not sufficiently address one of the two concerns expressed by CNE, which is that, when a Critical Day is called, a supplier like CNE must pay for replacement gas, the price of which, on a Critical Day, can be very high.

a. The CNE/Nicor Position

CNE proposed that Nicor should be required to permit super-pooling on Critical Days. On pages 38-41 of CNE's Initial Brief, it proposed that Nicor should allow all third-party groups, or pools, that are under common management, to be balanced in aggregate, before the application of Unauthorized Use Charges. Currently, when such an "unauthorized use" occurs, a Transportation customer faces two financial penalties, it incurs a $6 per therm penalty, and also, Nicor requires these customers to purchase replacement gas from Nicor, even though such a customer, when its pool is aggregated, has provided an ample supply of gas for all of its customers served in its various pools. Additionally, due to the demand pressure associated with Critical Days, replacement gas is typically purchased at a much higher price than the price on non-critical days. CNE Brief at 39.

CNE contended that it is amenable to Nicor's proposal whereby a supplier would apply for a waiver of the penalty portion of the Unauthorized Use Charge on a Critical Day for those "commonly-managed Rider 13 non common-ownership groups" when these groups substantiate that their other Rider 13 groups have excess deliveries of sufficient quantity to alleviate all, or a portion of, the unauthorized gas condition. It maintained that this proposal appears to alleviate the $6 per therm penalty portion of the Unauthorized Use Charge. However, according to CNE, Nicor's proposal did not address the replacement gas issue, (which is purchased from Nicor) that, with super-pooling, would not be required because, in the aggregate, sufficient gas deliveries would be made by the supplier to cover the actual use of all of the groups. *Id.* at 40.

CNE further averred in its Initial Brief that, in order for it to support Nicor's alternative process for super-pooling, both components of the Unauthorized Use Charges would have to be included. In order to reach some accord with Nicor, CNE stated that it was willing to accept Nicor's alternative process for super-pooling as it applies to the $6 per therm penalty portion of the Unauthorized Use Charge, provided that, in order to address the requirement that a customer purchase replacement gas on a Critical Day, Nicor should be required to collaboratively work toward a solution to address super-pooling for the purchased gas component of the Unauthorized Use Charge. CNE urged this Commission to adopt Nicor's proposal, but, it also submitted that this Commission should require Nicor to work collaboratively with interested parties to seek a super-pooling solution for the replacement gas component of the Unauthorized Use Charge. *Id.* at 40-41.

Subsequent to the time when the Initial Briefs were filed, CNE and Nicor reached an accord, in which Nicor agreed that it will implement its proposed alternate super-pooling process as was summarized in CNE's Initial Brief at pages 38-41, (set forth above) including the proviso that Nicor shall enter into collaborative sessions with interested entities to work toward a solution to address super-pooling for the purchased gas component of the Unauthorized Use Charge and report back to the Commission with the results. CNE Reply Brief at 13-14.

b. Staff's Position

Staff posited that CNE raised a concern that, in addition to the $6 per therm penalty, the price of gas that Transportation customers must 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 that is required to serve its customers, and Nicor would need to purchase no gas for any of these suppliers' customers at any price. Staff argued that the Nicor/CNE agreement does not adequately address that portion of CNE's concern that addresses the gas purchase requirement. Also, Staff recommended that the Commission approve the expansion of super-pooling to the requirements for the April 30th Spring cycling target because the logic for doing so is identical to that already approved for the Fall target of November 1st. Staff Reply Brief at 53-54.

c. Analysis and Conclusions

We decline to adopt Staff's recommendations. Nicor has agreed to enter into collaborative sessions with interested entities to work toward a solution to address super-pooling for the purchased gas component of the Unauthorized Use Charge and report back to the Commission with the results. It appears that Nicor has legitimate reasons for requiring that Transportation customers must have replacement gas on a Critical Day. However, as CNE has noted, with super-pooling, some customers will have, in the aggregate, sufficient gas deliveries. The better approach is to engage in discussions to determine how to best balance these two competing factors. We note that Nicor has averred that it will report back to the Commission with the results of the collaborative process it proposes.

Moreover, Staff set forth little to support its position that we should require expansion of super-pooling to require an April 30th Spring cycling target. Staff merely states that it is "logical" to do so, without stating facts establishing the need for such a requirement. We note, additionally, that the compromise reached between CNE and Nicor, which makes no mention of the April 30th Spring cycling target, is some indicia that Staff's proposal is not critical to the affected customers.

The compromises set forth above between CNE and Nicor are reasonable, practical processes and they are hereby adopted, as is set forth above. Nicor has one year from the date of this Order to file a report with the Manager of the Commission's Energy Division setting forth the results of the collaborative process set forth above.

13. Seasonal Usage Maximum

See, Section VIII(C)(5) herein.

X. TARIFF REVISIONS AFFECTING CUSTOMER SELECT CUSTOMERS

A. **OVERVIEW**

Interstate Gas Supply of Illinois, Inc. and Dominion Retail, Inc. (collectively the "Customer Select Gas Suppliers" or "CSGS") entered into a Memorandum of Understanding (an "MOU") with Nicor, wherein, the parties reached a comprehensive agreement regarding all small volume choice program issues, or the "Customer Select" issues. Nicor Initial Brief at 95-96.

B. **UNCONTESTED ISSUES**

As a result of the MOU, as was set forth in Section X(A) above, Nicor proposed that: 1) Customer Select customers shall receive a credit for gas in storage as part of the Transportation Service Credit; 2) Nicor will calculate Supplier's end-of-month Storage Inventory Target Levels during the winter as a percentage of month-end storage capacity, as opposed to a percentage of the preceding November 1 inventory; 3) that Customer Select Suppliers shall be allowed to cycle annually the additional operational balancing storage capacity of 6 times the Group's MDCQ effective as of the first May following the effective date of the tariff, and, also, permit the combined storage capacity of 34 times the Group's MDCQ as the basis for calculating monthly storage inventory target levels and the daily storage injection capacity; 4) to include the Account Charge in the base rates of all eligible customers; 5) to eliminate the $10.00 Group Addition fee as it relates to switching from one supplier to another and recover these costs through base rates; 6) to extend the number of days that a customer has to select a new Customer Select Supplier after returning to Nicor from another Customer Select Supplier from 45 to 120 days; 7) to make available to Customer Select Suppliers a residential customer mailing list; and, 8) to continue to meet with interested Customer Select stakeholders.

Customer Select Gas Suppliers witness Crist agreed the MOU is a comprehensive settlement covering all CSGS issues. CSGS Ex. 2.0 at 2-3. After reviewing MOU and responses to data requests, Staff recommended approving the resolution of issues as set forth in the MOU. Staff Ex. 24.0 at 41-47; Nicor Initial Brief at 95-96. The terms set forth above are reasonable and they are hereby approved.

XI. EXISTING RIDERS

A. RIDER 2 – FRANCHISE COST ADJUSTMENT

1. Nicor's Position

Nicor proposed to continue to recover franchise costs from appropriate customers on a monthly basis under Rider 2, Franchise Cost Adjustment, but, it would like to modify Rider 2 to provide for annual updates to charges based upon the actual costs incurred. Nicor Ex. 14.0 at 30. Nicor proposed to amend Rider 2 to provide for the filing of an information sheet on or before April 20th of each year that specifies the franchise cost adjustment charges to be applicable for the subsequent 12 months. The amount to be recovered would be based on the actual costs of providing reduced rate service or other monetary contribution to the local governmental units during the previous calendar year. Staff witness Boggs recommended approving this proposal. Staff Ex. 8.0 at 4.

2. Staff's Position

Staff witness Hathhorn recommended that Nicor include supporting work papers with its annual filing. Staff Ex. 2.0 at 33. Nicor accepted this recommendation Nicor Ex. 29.0 at 48. Nicor's proposal to change Rider 2, together with Staff's recommended revisions, has not been challenged by any other party.

3. Analysis and Conclusions

Staff opined that this is an improvement from the previous cost recovery mechanism because it mitigates the potential for customers to be over- or under-charged relative to the costs that the Company incurs. The Commission would be able to monitor the status of these costs annually, based on the information sheet to be submitted annually by the Company and would be able to adjust the cost recovery accordingly. The Commission finds that Nicor's proposal to modify Rider 2, together with Staff's recommended revision, is just and reasonable. It is hereby approved.

B. RIDER 5 – STORAGE SERVICE COST RECOVERY

Nicor proposed two update factors within Rider 5 based on the results of the ECOSS. No party objected to these proposed changes. We conclude that Nicor's Rider 5 updates are reasonable. They are hereby adopted.

C. RIDER 8 – ADJUSTMENTS FOR MUNICIPAL AND STATE UTILITY TAXES

Nicor proposed to modify Rider 8 to include taxes by other local governmental units. It agreed to clarify its proposed revisions to Rider 8 wherein it, based upon audit results, refund over-collections to customers. Tr. 387-388. Staff recommends that the Commission approve the Company's revised proposal, subject to Staff's refund of over-collection provision, and Nicor's proposal to clarify its authority to collect payments resulting from audit adjustments imposed by Municipalities, Local Governmental Units or the State. Staff Cross Ex.3, NRC Staff 3.01. No other party addressed the modifications to Rider 8. Staff's recommendation is reasonable and it is hereby approved.

XII. NEW RIDERS

A. OVERVIEW

Nicor proposed five new riders. Nicor stated that its Rider 26, its Uncollectible Expense Adjustment ("Rider UEA") and Rider 27, Company Use Adjustment ("Rider CUA") respond to significant year-to-year volatility in natural gas prices. Rider 28, Volume Balancing Adjustment ("Rider VBA") and Rider 29, Energy Efficiency Plan ("Rider EEP") are, according to Nicor, designed to break the direct link between delivery volumes and Nicor's recovery of its fixed costs. Finally, Rider 30, Qualifying Infrastructure Plant ("Rider QIP") establishes a mechanism for certain additional capital investments that, Nicor avers, will facilitate the ongoing replacement of old cast iron main and copper services.

1. Rider 28 – The Volume Balancing Adjustment (The "VBA")

Nicor proposed a rate design in Rider 28, Rider VBA, that would separate or "decouple," the revenues it receives from its delivery charge, which is a volumetric charge, from fluctuations in its sales of natural gas. This "decoupling" would occur for Rates 1, 4 and 74. Nicor proposed to implement Rider VBA on a pilot basis for a four-year period. Nicor Initial Brief at 109.

Staff proposed that, if this Commission approves Rider VBA, it should remove the portion of Nicor's formula that calculates the charge based upon the number of Nicor's customers as of the time of this proceeding. Staff recommended imposing a "full decoupling," instead of Nicor's proposed "partial decoupling." With "full decoupling," Staff asserted, any increase in the actual number of customers that Nicor serves would not result in Nicor recovering more money for its fixed costs than the amount of the approved revenue requirement pursuant to this docket. The AG argued, however, that Nicor's proposal to impose this Rider should be denied.

Nicor agreed to implement five changes to this Rider that were proposed by Commission Staff, if this rider is approved. These changes are: a.) to correct the definition of "Previous Reconciliation Period" in the Rider; b.) to modify the computation of the RA1 Reconciliation Adjustment to be consistent with the formula approved by the Commission in the 2007 Peoples Gas Rate case; c.) to incorporate the suggested relocation of language from Section D in the Rider to Section C therein, as well as the addition of language to Section C; d.) to annually report the effects of Rider VBA on Nicor's rate of return; and e.) to add a tariff requirement for an annual internal audit report to be filed with this Commission. Nicor Initial Brief at 111.

a. Nicor's Position

Nicor asserted that most of the operating costs that are included in its base rates are fixed costs because Nicor will incur those costs without regard to the volume of gas it delivers. Even though these costs are constant, pursuant to Nicor's current rate design, a substantial portion of these fixed costs are collected through charges that are determined based upon the volume of gas delivered. Nicor Ex. 12.0 at 20.

However, due to conservation efforts, poor economic conditions and weather conditions, Nicor is not receiving sufficient funds to cover the fixed operating costs that were approved in its 2004 Rate case. According to Nicor's witness Mr. O'Connor, there is a continuing decline in the amount of gas that Nicor delivers to a given customer. This is a national phenomenon. Nicor averred that it will not generate sufficient revenue in a given year to fully recover the fixed costs approved by this Commission in Nicor's 2004 Rate Case, if it delivers lower volumes than those that were used in the design of Nicor's volumetric charges at that time. *Id.* at 20-21.

Mr. O'Connor testified that in Nicor's 2004 Rate Case, the average annual normalized gas consumption per residential space heating customer was 1,183 therms. By 2009, the average annual normalized consumption per space heating customer will decrease by 95 therms to only 1,088 therms. Considering that Nicor has about 1.9 million residential space heating customers, that difference amounts to a loss of about 187 million therms of delivered gas on an annual basis. At Nicor's current rates, this loss translates into a base revenue loss of Commission-approved costs in the amount of $9.7 million, approximately, on an annual basis. *Id.* at 21.

In general, Rider VBA would make monthly adjustments for the difference between the average base distribution revenue per customer, as determined in this proceeding, and the actual average (base distribution) revenue per customer. Base distribution revenue is the revenue that Nicor derives from volumetric charges. It does not include monthly customer charge revenue, the commodity costs of gas, environmental cost recovery, taxes and other such revenues. *Id.* at 22. Any difference between actual billed revenues arising from distribution charges, and, the adjustment for the approved distribution margin under Rider VBA, will be reconciled on an annual basis and amortized over the nine-month period beginning in April, with any resulting positive or negative adjustments added to, or subtracted from, customers' bills during that period. Nicor Initial Brief at 110.

Once the difference between the rate-case determined base distribution revenue per customer and the actual base distribution revenue per customer is determined for a month, this difference is then multiplied by the number of customers, as is determined in this proceeding, to reach a total revenue adjustment. This total revenue adjustment is then divided by the forecasted therm deliveries for the next month. Nicor Ex. 12.0 at 23. Stated another way, this Rider would permit Nicor to adjust, on a monthly basis, the amount of volumetric base rate revenues it receives to match the level of volumetric base rate revenue per customer that is approved in this docket. The adjustment made pursuant to Rider VBA either results in a charge or a credit to a customer. Nicor Initial Brief at 109.

Mr. O'Connor testified that only the delivery portion of a customer's bill, or, an amount that is approximately 20% of the total bill, is subject to adjustment pursuant to Rider VBA. Nicor Ex. 12.0 at 23. The average distribution revenue per customer assumed in this proceeding will be determined based upon normal weather conditions. If everything else is equal, weather that is colder than normal equates to higher deliveries and higher revenues. On the other hand, weather that is warmer than normal would yield lower deliveries, as well as correspondingly lower revenues. Thus, Rider VBA adjusts for the effects of the weather, as well as energy conservation, upon the revenue that Nicor receives pursuant to the delivery charge. Nicor Ex. 12.0 at 23.

He stated that Nicor is proposing Rider VBA, a revenue-stabilization, or a "de-coupling" mechanism. It is also proposing Rider EEP as a funding mechanism for a new energy efficiency plan to promote increased conservation on the part of its consumers. Mr. O'Connor also averred that Rider VBA benefits ratepayers because it solves the rate design problem that impedes energy conservation. Nicor's current rate design penalizes it financially when consumers conserve energy, even though conservation is in the public interest and in the best interest of ratepayers. Under Nicor's current rates, it is rewarded financially by increased gas consumption on the part of its customers. However, Nicor is penalized financially when its customers use less gas. Rider VBA addresses this problem by de-coupling the revenue that Nicor needs to fully recover its fixed operating costs from delivery volumes. *Id.* at 22, 24-25.

Additionally, ratepayers could benefit from Rider VBA by receiving some relief from higher gas bills during periods when the weather is colder than normal. For a month with colder than normal weather, Rider VBA would offset higher gas bills by providing a bill credit in a future month. *Id.* at 24.

Mr. O'Connor acknowledged that Nicor seeks, in this docket, to adjust its monthly customer charge to recover a larger portion of its fixed operating costs through its fixed charges. However, even with the proposed shift of adding some of Nicor's fixed operating costs to monthly customer charges, a significant amount of Nicor's fixed operating costs would still be recovered through volumetric charges. While the amount of Nicor's exposure to revenue loss due to reduced deliveries would be mitigated by Nicor's proposed rate design for Rate 1, in Mr. O'Connor's opinion, this rate design would, by no means, correct the problem. He stated that Nicor already is moving toward an SFV rate design with its proposed adjustment to monthly customer charges.

He opined that in the interim, Rider VBA is an appropriate mechanism to assist in the recovery of Nicor's fixed charges. *Id.*

Nicor averred that the monthly adjustment pursuant to Rider VBA will be computed using actual and rate case information from the second month before the effective month of the adjustment. For example, the Rider VBA amount computed based on October results will be applied to customer bills rendered in December. A baseline distribution margin, per customer, by month, and average number of customers, will be established as of the time of this docket. Nicor Initial Brief at 110.

However, Nicor opposed Staff witness Ms. Jones' proposal to alter the formula used to calculate the customer charge. It argued that Ms. Jones' proposal to include new customers in the calculation of the charge imposed pursuant to Rider VBA adds costs that are not reflected in the current costs that are considered in this proceeding. If new customers are added without additional revenues to offset those new costs, Nicor averred that it will need to seek rate relief sooner than the time that Nicor anticipated. Nicor Initial Brief at 111.

b. Staff's Position

Staff argued that it is evident, from the Commission's decision to approve a Rider VBA in Docket 07-0241, (the Peoples Gas Rate case) that this Commission is willing to consider alternatives to the traditional method of recovering a portion of fixed costs through the volume-based portion of a customer's bill. It is also evident, from the fact that Rider VBA was approved as a pilot program in that case, that the Commission is interested in evaluating VBA methodology before giving permanent approval of a VBA Rider. Staff noted, however, that what the Commission approved in the Peoples Gas Rate Case was structured as a partial decoupling mechanism. Staff asserted that if, in the instant proceeding, the Commission were to approve recovery of fixed delivery service costs through a pilot program that is different from the one approved in the Peoples Gas Rate Case, there would be more information available to evaluate which is the better method. *Id*. at 30-31.

However, Staff did not make a recommendation regarding whether this Commission should approve Rider VBA. Staff Witness Ms. Jones simply provided this Commission with an alternative to what Nicor proposes, which this Commission may consider, should it decide to approve another rider pilot program. Staff Ex. 3.0 at 29-30.

Staff witness Ms. Jones testified that Rider VBA, as proposed, is a partial decoupling mechanism, in that, it tracks changes in customer usage on a per customer basis. She stated that Nicor has proposed to design Rider VBA calculations so that it will recover a set amount per customer, based on the number of customers assumed in this rate case proceeding, plus or minus any amount of revenue that is due to any increase or decrease in customers. Thus, pursuant to Nicor's proposal, any increase or decrease in customers could result in Nicor recovering more or less from its customers than the actual amount of fixed costs to be recovered. Staff Ex. 16.0 at 12-13.

She stated that Rider VBA could be structured in a manner that is determined based upon the fixed cost portion of the volumetric charges on a total revenue requirement basis. This is known as full decoupling. With full decoupling, if the actual revenue billed for fixed costs were to be less than the amount included in the revenue requirement approved by the Commission, the VBA rate would be positive, resulting in a charge to customers. If the actual revenue billed for fixed costs were to exceed the amount included in the approved revenue requirement, the VBA rate would be negative, resulting in a refund to customers. With full decoupling, any increase in the actual number of customers that Nicor serves would not result in Nicor recovering more for fixed costs than that which the Commission approves here in Nicor's revenue requirement. Staff Ex. 3.0 at 28-29.

For Rider VBA to function as a full decoupling mechanism, the formulas for the Effective Component and the RA_1 component of the Reconciliation Adjustment would be modified as follows:

(1) Effective Component – The adjustment, determined for each Service Classification, to be billed for the Effective Month is represented by the following formula:

~~[(RCM / RCC) – (AM / AC)] x PFC x RCC / T x 100~~

<u>(RCM – AM) x PFC / T x 100</u>

Where:

RCM represents the Rate Case Margin for the Reconciliation Month.
~~RCC represents the number of Rate Case Customers for the Reconciliation Month.~~
AM represents the Actual Margin for the Reconciliation Month.
~~AC represents the number of Actual Customers for the Reconciliation Month.~~
T represents the forecast Factor T for the Effective Month.
PFC represents the percentage of Nicor's costs that are fixed as determined and authorized by the Commission in its most recent rate proceeding.[20]

(2) Reconciliation Adjustment

RA_1 shall be represented by the following formula:

~~(RCM – (AM/AC x RCC)) x PFC – VBAR~~[21]

<u>(RCM – AM) x PFC - VBAR</u>

[20] PFC is 80.47% of Nicor's fixed costs. *See,* Nicor Ex. 29.0 at 54.

Where:

RCM represents the Rate Case Margin for the Fiscal Year.
AM represents the Actual Margin for the Fiscal Year.
~~AC represents the average number of Actual Customers for the fiscal year.~~
~~RCC represents the average number of Rate Case Customers for the Fiscal Year.~~
VBAR represents the sum of the actual monthly revenues arising from the application of the Effective Component in Section B: (1) for the Fiscal Year

O represents the Ordered adjustment, in dollars ($), determined by the Commission that is to be refunded to or collected from customers as a result of the reconciliation established in Section C.
PFC represents the percentage of Nicor's costs that are fixed as is determined and authorized by the Commission in Nicor's most recent rate Proceeding.

Id. at 29-30.

Essentially, Ms. Jones' changes to Nicor's proposed formula remove the number of "rate case customers" from the formula. This, in effect, forces Nicor to spread the difference between what this Commission approves as base distribution revenue and Nicor's actual revenue over all of Nicor's customers in the affected rate classes at any given time, based on the actual number of customers in those classes at that time, as opposed to the number of customers that Nicor has now. Ms. Jones' formula thus requires Nicor to determine the applicable charge based on the actual number of affected customers at any given point in time. This removes the possibility that she addressed, which is, that if Nicor makes this calculation based upon a number of customers that is too low, due to an increase in the number of customers that Nicor serves after the time that this Order is entered, Nicor can experience a windfall based upon the difference between the amount of customers in the calculation and the actual number of customers. It also ensures that any increase in the number of Nicor's customers results in a corresponding decrease in the charge per customer.

c. The AG's Position[22]

i. The AG's Factual Arguments

The AG's witness Mr. Rubin averred that Nicor's proposed Rider VBA would allow Nicor to reconcile, on a customer class basis, its actual level of distribution charge revenues per customer (which is also called the "margin") to the average level of such revenues that is projected in this rate case. Mr. Rubin, however, does not think that Nicor's VBA is reasonable. AG/CUB Ex. 2.0 at 18.

[22] CUB has adopted the AG's arguments regarding the new riders that Nicor proposes, including this one. CUB Initial Brief at 32.

He testified that Nicor's decoupling proposal improperly assumes that every customer that is added after this case ends uses the same amount of natural gas as the average existing customer. However, there is no evidence showing how the costs incurred in serving new customers compare to the costs Nicor expends to serve its existing customers. For example, Nicor makes substantial expenditures each year to maintain, repair and replace old distribution mains. He testified that these are the type of fixed costs that Nicor seeks to recover through its decoupling rider. However, these costs are not incurred to serve new customers. *Id.* at 19.

He further opined that it is not reasonable to expect a new customer to use the same amount of gas as that which an average existing customer would use. New gas appliances, especially space heating systems, are much more efficient than older appliances. New dishwashers, washing machines and showerheads use hot water much more efficiently than older models. Also, new homes tend to be much more insulated than older homes. He also testified that the U.S. Department of Energy completed a survey in 2001. At that time, this survey showed that the space heating intensity for homes heated with natural gas that were built between 1990 and 2001 was 4.688 cubic feet of gas per heating degree day per 1000 square feet of heated space.[23] Homes built before 1950, on the other hand, were nearly half as efficient as newer homes. He concluded that therefore, it does not appear to be reasonable to assume that new homes should use the same amount of natural gas as existing homes. *Id.*

Also, according to Mr. Rubin, Rider VBA fundamentally changes the relationship between a utility and its customers. Utilities have never been "guaranteed" a certain rate of recovery from their customers. Instead, the ratemaking process merely provides a utility with an opportunity to earn a particular return based on a test-year estimate of the amount of services that it will sell. He concluded that a utility takes the risk that a customer might demand more or less of a service than it expects. In return, a gas customer bears the costs and risks that would not be borne in a competitive environment. He additionally opined that, because decoupling seeks to have customers collectively guarantee a certain level of sales to a utility, it provides a disincentive to ensure that the utility can reliably deliver gas on demand to customers. AG/CUB Ex. 2.0 at 21-24.

Mr. Rubin testified that Nicor's rates are designed to recover some fixed costs in the per-therm distribution charge paid by Rate 1 and 4 customers. The AG asserted that, whether Nicor earns its authorized return is not necessarily or solely a function of declines in revenue on a per customer basis. Other factors, such as increases in the price of materials, can cause a drop in earnings. Therefore, adjusting rates in isolation, based on designated benchmarks, (in this case, revenue) does not account for other dynamic components of Nicor's expense and revenue streams. AG Initial Brief at 59-60.

In response to an AG discovery request, Nicor stated that it expects to add more than 20,000 customers from 2008 to 2009, which is about a 1% increase in Nicor's customer base. Mr. Rubin pointed out that when it adds new customers, Nicor actually

[23] Mr. Rubin defined space heating intensity as the amount of fuel used, (in cubic feet of natural gas) divided by heating degree days, times the heating square footage per 1000. AG/CUB Ex. 2.0 at 20.

experiences an increase in revenues. Thus, he concluded that even though Nicor would be receiving more revenue from new customers, Nicor suggests that it would not be receiving enough new revenue to recover its costs and earn a reasonable return. However, according to Mr. Rubin, it is not possible to determine how much Nicor needs to recover its costs and earn a reasonable return without examining the expenses, investments, and capital costs involved in serving all customers, old and new. AG/CUB Ex. 2.0 at 19, 25.

ii. The AG's Legal Arguments

The AG argued that Nicor's Rider VBA contravenes the principles of utility ratemaking that were articulated by the United States Supreme Court and the Illinois Courts. Precedents such as *Bluefield Waterworks Improvement Co. v. Public Service Comm. of West Virginia,* 262 U.S. 679, 692-93, 43 S. Ct. 675 (1923), recognize that regulation does not insure that a utility will produce net revenues, as, regulation does not entitle a utility to protection from market realities like competition, or, the effect of price on a consumer's demand. Citing *Camelot Utilities v. Illinois Commerce Comm.,* 51 Ill App. 3d 5, 365 N.E.2d 312 (3rd Dist. 1977), the AG contended that the law contravenes Nicor's request for "guaranteed" recovery, through Rider VBA, of designated revenue streams in the affected customer classes. AG Initial Brief at 60-63.

The AG maintained, citing *A. Finkl & Sons Co. v. Illinois Commerce Comm., ,* 250 Ill. App. 3d 317, 620 N.E.2d 1141 (1st Dist. 1993), that rider recovery constitutes extraordinary regulatory treatment that should only be used when compelling evidence exists establishing that traditional ratemaking will not effectively reflect the cost in rates. To qualify for rider recovery, the expenses to be recovered must be unexpected, volatile or fluctuating. They also must be significant. Also, pursuant to *A. Finkl & Sons,* 250 Ill. App, 3d at 317, because Rider VBA recovers lost revenue, the AG argued that it is illegal. AG Initial Brief at 66-67, *A. Finkl & Sons,* 250 Ill. App. 3d at 328.

Here, however, the AG continued, the changes in Nicor's revenues from the time period from 1998 through 2007 are not large when compared to the total test year operating income of $67.8 million. For example, if Rider VBA had existed in 2000, Nicor would have been compensated in the amount of $3.4 million. In 2007, that amount would have been $10.4 million. Also, the annual margin dollar changes are not volatile ones. The AG pointed to Nicor's assertion that declining use per customer has been a phenomenon since at least 1996, and concluded that therefore, declining use is not unexpected. AG Initial Brief at 63-65.

The AG additionally argued that Nicor's proposed Rider VBA violates the prohibition in the Public Utilities Act against single-issue ratemaking. Instead of considering costs and earnings in the aggregate, the AG continued, where potential changes in one or more items of expense may be offset, Nicor's Rider VBA considers only the benchmark per-customer margin revenues in isolation. Because Rider VBA ignores the totality of circumstances, the AG concluded that it constitutes single-issue ratemaking. *Id.* at 65-66.

The AG proffered that Rider VBA adjusts future residential customer bills based on an adjustment that is retroactive, in violation of 220 ILCS 5/9-201. This is so, the AG reasoned, because the Rider VBA amount to be computed based on one month, *e.g.,* October, would be applied to customer bills two months later, in December. *Id.* at 67-68.

The purpose of the test-year requirement is to prevent a utility from overstating its revenue requirement by mismatching low revenue information from one year with high expense information from a different year. The AG concluded that Rider VBA violates the test-year principle by tracking changes in revenues, per customer, in isolation, and then assessing rate adjustments to recognize this change, without examining other operating expenses and rate base components of the test year revenue requirement. Because Rider VBA selects only one component of the revenue requirement, which is, margin revenues per customer in the affected rate classes, the AG concluded that it violates the test-year principle. *Id.* at 68-69.

The AG finally argued that Rider VBA violates the Public Utilities Act's prohibition against discriminatory rates, citing 220 ILCS 5/9-241. The AG asserted that, in proposing Rider VBA, Nicor seeks to maintain a designated level of revenues, per customer, on a monthly basis for residential, commercial and one transportation class, (Rates 1, 4 and 74) but, it does not seek the same from other customers. The AG pointed out that while Nicor has asserted that it needs a decoupling mechanism to adjust for the effect of declines in usage per customer, Nicor did not present evidence establishing that the phenomena that trigger usage decline, such as abnormally warm weather and conservation, are unique to the three customer classes to which Rider VBA would be applied. *Id.* at 69-70.

d. Analysis and Conclusions

The Commission has concluded herein (see the analysis and conclusions sections for Rate 1 and Rates 4 and 74) that Nicor's Alternative SFV rate design for Rate 1 is accepted and Rider VBA is, therefore, denied.

2. Rider 26 – The Uncollectible Expense Adjustment Rider ("UEA")

Nicor proposed to add a rider that would allow it to recuperate its uncollectible accounts from those ratepayers that pay their bills whenever the amount of its uncollectible expense exceeds 105% of the Commission-approved amount of uncollectible expense that is determined in this proceeding. Similarly, if Nicor's rate of uncollectible expense were to fall below 95% of that amount, ratepayers would receive a credit representing the difference between 95% and 100% of this amount and the actual amount of uncollectible expense. Staff and the AG oppose this proposal.

If the Commission were to approve Rider UEA, Staff proposed four changes to this Rider, to which Nicor agreed. These changes are: (1) an annual docketed reconciliation proceeding, which includes a Factor O for Commission-ordered adjustments in the tariff formula; (2) a prudency and reasonableness of costs determination in such a reconciliation proceeding; (3) an annual internal audit with specific tests; and (4) a better defined calculation of uncollectible expense under Rider UEA. Nicor Initial Brief at 102.

a. Nicor's Position

Nicor averred that one of the factors driving its request for a rate increase here is the sustained high market price of natural gas that occurred after the 2005 hurricane season. Nicor witness Mr. O'Connor testified that the price of natural gas prices is the most important factor affecting Nicor's expenses. Nicor contended that Rider UEA is intended to address the significant year-to-year volatility in the market price of natural gas, which, it maintained, is beyond any prudency efforts that its management efforts can sustain. Natural gas prices, it maintained, are very volatile, when compared to Nicor's other O&M expenses. Nicor pointed out that Staff agrees that natural gas prices are "very volatile." Nicor Ex. 12.0 at 4-11.

Nicor stated that natural gas prices have had a substantial negative impact on its opportunity to recover its gas-related costs. Natural gas prices directly affect the level of the Nicor's Uncollectible Expense, due to the close correlation between gas prices and Uncollectible Expense. As a result, Nicor's Uncollectible Expense has become a significant portion of Nicor's operating expenses, rising from approximately $38.5 million that was approved in Nicor's 2004 Rate Case to $53 million in 2007, and on to approximately $68.3 million projected for the test year. Nicor argued that its Uncollectible Expense is more than 21% of its forecasted O&M for the 2009 test year. Nicor Initial Brief at 103.

Pursuant to Rider UEA, Nicor would either recover from customers, or, credit to customers, any amount that falls outside of the 95% to 105% range set forth in Rider UEA. Rider UEA starts with a Commission-approved "deadband" for Uncollectible Expense that is recovered through base rates.[24] If Nicor's actual Uncollectible Expense in the preceding year is less than 95% of the Commission-approved amount, Nicor would refund the difference to customers, on a cents per therm basis, during April through December. Conversely, if the actual Uncollectible Expense in the preceding year is more than 105% of the amount established here, Nicor would recover the difference from customers, on a cents per therm basis, during April through December. Nicor Gas Ex. 14.0 at 34.

Nicor acknowledged that those opposing the imposition of Rider UEA assert that its uncollectible expenses are not volatile in comparison to other system costs. It asserted, however, that the rate of change to its Uncollectible Expense is closely correlated to the change in natural gas prices. Nicor also averred that Illinois case law regarding the use of riders does not demand a rigid adherence to tests for "volatility" or, whether uncollectible expense is beyond the Company's control. Nicor Reply Brief at 104.

Nicor disagreed with Staff's assertion that it has not increased its efforts to address uncollectible expense despite the increasing trend of bad debt. In rebuttal

[24] A "deadband" is the portion of the expense that would not be subject to recovery through the proposed rider.

testimony, Nicor provided evidence of its extensive collection efforts. Nicor also disagreed with Staff's contention that the 5% deadband provides it with a disincentive to disconnect customers for non-payment. Nicor averred that this argument does not comport with the reality of the collection process. Disconnection of service is a final step in a long process, and it is, in large part, governed by the dictates of Part 280. Nicor's efforts to recover past due amounts do not depend upon whether those past due amounts will ultimately end in disconnection. Instead, Nicor's incentive is to ensure that it does not have a cash shortfall. Nicor averred that this incentive negates any "hypothetical incentive" of encouraging non-paying customers to remain connected, as envisioned by Staff and the AG. Nicor Reply Brief at 105-06.

Nicor further submitted that what it proposes is a mechanism that treats both ratepayers and the Company symmetrically. It concluded that Staff's argument regarding the fairness of the risk-shifting to ratepayers ignores the truth that uncollectible accounts, are, in the end, generated by ratepayers themselves when they fail to pay their bills. However, the factors creating the current amount of uncollectible accounts are beyond the control of Nicor's ratepayers, as well as beyond Nicor's control. Nicor Reply Brief at 103-4.

b. Staff's Position

Staff contended that the Commission should reject Rider UEA because the benefits of this rider would not justify the attendant costs. Staff asserted that this rider is one-sided. As the financial risks increase within Nicor's service territory, Nicor seeks a solution that protects it by shifting further risk to ratepayers. According to Staff, this just exacerbates the negative economic climate. Staff Ex. 7.0 at 7-8.

Staff maintained that the design of Rider UEA is fatally flawed because Nicor would have the appropriate incentive (the incentive to collect on its past due accounts) only when its overall uncollectible expense falls within the deadband zone. This is true, Staff continued, because uncollectible expenses within that zone are essentially treated as base rate expenses. However, once the amount of uncollectible expense falls outside this zone, Nicor has the incentive to increase, rather than reduce, uncollectible costs and pass the shortfall along to its paying customers. The problem when Nicor's uncollectible expense exceeds the deadband amounts, Staff concluded, is that this rider enables Nicor to fully recover a non-paying customer's bill from other customers.

Essentially, Staff stated that Nicor's proposal would allow it to "sit on" and therefore not actively process and pursue, its uncollectible accounts, so that these accounts would be absorbed by Nicor's paying customers. Staff averred that the assurance of full recovery would create a disincentive for Nicor to disconnect non-paying customers. Upon disconnection, Nicor would no longer receive the revenues associated with the disconnected customers' bill. Pursuant to Rider UEA, disconnection would create revenue erosion for Nicor. As long as ratepayers in good standing can absorb the additional costs pursuant to this rider, Nicor would not have the incentive to shut customers off when its' uncollectible expense exceeds the amount in the deadbandlevel. Staff Ex. 7.0 at 14-15.

Staff further stated that a similar incentive issue would arise when Nicor's uncollectible expense falls below the deadbandlevel and customers receive credits under Rider UEA. When customers fail to pay their bills, Nicor can reduce the flow of credits back to other customers by the unpaid amount under Rider UEA. If these customers were disconnected, the Rider UEA credit flowing back to customers in good standing would not be reduced by the bills of the non-paying customers. Staff concluded that therefore, Nicor would suffer a revenue erosion equal to the bills these customers would have generated, if they had remained on Nicor's system. The incentive again would be for Nicor to keep nonpaying customers on the system and make the paying customers responsible for the non-paying customers' bills. Staff opined that providing this kind of incentive would not be good regulatory policy. Staff Initial Brief at 145.

Staff also averred that, in fact, the cost of natural gas is not volatile in comparison to other system costs. Staff presented three graphs comparing Nicor's uncollectible expense to the other costs it incurs. It opined that its charts clearly demonstrate that Nicor's uncollectible expenses do not meet that customary standard for volatility that justifies implementing a rider. Staff acknowledged that Nicor has increased its efforts to decrease the amount of its uncollectible expense, but, Staff maintained, it would make sense to give Nicor the maximum incentive to continue to pursue its past-due customers. Staff Initial Brief at 140-143.

Staff contended that a finding of imprudency in an annual reconciliation is not a sufficient motivation for Nicor to control its uncollectible costs. A finding of imprudency is a "rare and difficult task for the regulatory process." Also, an additional rider makes it more difficult for Staff to assess the prudence of Nicor's costs. Significant Staff resources are required to oversee recovery for each rider to make sure that only reasonable costs are passed along to ratepayers. A new rider adds a new set of Commission duties to ensure that only reasonable costs are passed along to ratepayers. Staff Ex. 20.0 at 4.

Staff further opined that the increase in the number of foreclosures that is occurring is indicative of the increasing financial difficulties for Nicor's customers. This may impair their ability to pay higher gas bills through the application of a rider. Staff Initial Brief at 143.

c. The AG's Position

The AG argued that Nicor's proposed Rider UEA would permit Nicor to automatically recover any changes to its uncollectible accounts expense that is outside of the "deadband." Rider UEA would insulate Nicor from changes in the level of uncollectible bills from its customers, except for the first 5% that is above or below the test year level of uncollectible expense. For example, if the base level of uncollectible expense is set at $10 million and the actual level of uncollectible expense is $12 million, Nicor would be able to automatically recover an additional $1.5 million from its paying customers, with the first $500,000 not being recovered through this rider. Similarly, if the level of expense declined to $8 million, Nicor would be required to refund $1.5 million to these customers. AG/CUB Ex. 2.0 at 8-9.

The AG submitted that, in Nicor's last rate case, Docket 04-0779, Nicor proposed to include in its Rider 6 (Gas Supply Cost) the commodity-related portion of uncollectible accounts expense. However, the Commission rejected this proposal, stating:

> Commodity-related uncollectible expense should not be split from other uncollectible expense. The Commission agrees with Staff and CUB/CCSAO that costs, such as uncollectible expense, which are a normal cost of the provision of service, do not warrant special recovery through a rider. Nicor has not met its burden of showing that these costs are of a nature that should be recovered through a rider rather than through base rates. The gas cost portion of Nicor's uncollectible expense is presently being recovered through base rates, and should continue to be recovered through base rates.

AG Initial Brief at 37, quoting the Nicor Rate Case Order at 181.

The AG further averred that automatic rate adjustments should be used sparingly. AG/CUB witness Mr. Rubin testified that riders, if used at all, should be limited to costs that are outside of a utility's control, and which are not related to other revenue or expense items. Uncollectible accounts expense, which is a normal cost of the provision of service, does not meet either of these criteria.

The AG asserted that the level of uncollectible accounts is, to a significant extent, within a utility's control. Nicor has a few programs that are designed to help low-income and payment-troubled customers better afford their bills and to encourage them to pay their bills on time. However, Mr. Rubin noted that Nicor's programs appear to be designed to affect a customer once he or she is identified as being payment-troubled. To Mr. Rubin, it does not appear that Nicor proactively tries to help low-income customers manage their energy bills. In addition, with the deteriorating economy, Nicor should be evaluating ways to further expand its programs to assist moderate-income customers who have fallen on hard times. AG Initial Brief at 38.

Also, to the AG, Nicor's proposed rider would be unacceptable as a matter of public policy. Nicor is projecting a $10.3 million increase in uncollectible expense from 2008 to 2009. In total, from 2006 through 2009, Nicor is projecting a total increase of more than $30 million. If this increase does not occur, Nicor could receive a windfall of up to $3.4 million, which is 5% of the projected $68.3 million expense, through the operation of the deadband in Rider UEA. *Id.* at 39.

Additionally, according to the AG, it is unreasonable for Nicor to attempt to automatically recover increased uncollectible expense, rather than taking actions to try to control its level of uncollectible expense. The AG submitted that the amount of uncollectible accounts expense can be related to the level of utility expenditures on other measures, such as collections, customer service, usage reduction, and consumer education. The AG concluded that by allowing Nicor to recover increases in its uncollectible expense, but not increases in its expenditures on other measures that could directly benefit payment-troubled customers, the Commission would create a disincentive for Nicor to better serve customers and control its uncollectible expense. *Id.*

The AG further contended that Rider UEA is illegal because it violates the Public Utilities Act's prohibition against single-issue ratemaking, as, the Public Utilities Act prohibits the Commission from considering changes to components of the revenue requirement in isolation. Nicor's proposed Rider UEA, however, would permit Nicor to automatically recover any changes in its uncollectible accounts expense outside of the 5% deadband. The AG asserted that, instead of considering costs and earnings in the aggregate, where potential changes in one or more items of expense or revenue may be offset by increases or decreases in other such items, Nicor's Rider UEA considers changes in uncollectible expense in isolation, which ignores the totality of circumstances and is therefore illegal single-issue ratemaking. AG Initial Brief at 40-41.

The AG also maintained that Nicor's proposed Rider UEA violates the prohibition in the Public Utilities Act against retroactive ratemaking by enacting changes in rates outside of the ratemaking process. This is true, according to the AG, because any difference between billed revenues and uncollectible expenses would be reconciled annually and amortized over a nine-month period. *Id.* at 41-42.

Further, the AG contended, Rider UEA's recovery of additional revenues for uncollectible expense beyond those that are approved in this docket violates the Commission's test year rule. The AG opined that the purpose of the test-year rule is to prevent a utility from overstating its revenue requirement by mismatching low revenue evidence from one year with high expense evidence from a different year. However, pursuant to what Nicor proposed, Rider UEA would deviate from this process and provide piecemeal rate increases or decreases for uncollectible expense fluctuations between rate case test years. According to the AG, Rider UEA violates the Commission's test-year principles by selecting only one component of the revenue requirement, tracking changes in that revenue requirement component, and then assessing rate adjustments to recognize this change on a single-issue basis. *Id.* at 42-43.

d. Analysis and Conclusions

We conclude that this rider should not be approved. As the AG noted, Nicor's Uncollectible Expense is an expense that Nicor incurs every year. The only factual assertions that Nicor has made in support of using a rider to recover something it incurs every year are the bad economy and the volatile price of natural gas. However, these two factors, without more, do not justify recovering uncollectible accounts through a rider, which within certain parameters would allow Nicor to recover the bills of its customer who do not pay their bills from those who *do* pay their bills.

We also agree with Staff's assertion that imposition of the rider in question creates a revenue erosion, in that, as long as customers who pay their bills can "foot the bill" for Nicor's past due customers, Nicor has an incentive to refrain from actively collecting from the customers who actually incur the past due bills. This rider creates an incentive to pass any shortfall onto paying customers, rather than attempt to collect from the customers who actually incurred past due bills.

We acknowledge that Nicor needs to collect its bills in order to function as a business, and, therefore, Nicor has the incentive to have a sufficient revenue stream so that it can conduct business. However, this just means that Nicor has a natural incentive to ensure that it has a sufficient revenue stream; it does not, in and of itself, provide an incentive for Nicor to care where that money comes from. Where the money comes from, paying customers, versus nonpaying customers, is the crux of the issue here.

Nicor argues that ratepayers, as a group, should bear the cost of its uncollectible expense because they incur those costs. In so arguing, however, it ignores the fact that it is only the ratepayers that do not pay their gas bills who incur those costs. While Nicor asserts that it is just not fair for it to bear the burden of an increase in its uncollectible expense, it is equally unfair to burden its' paying customers with the bills incurred by its non-paying customers.

We further note that, unlike Nicor's paying customers, Nicor has a remedy if its rate of non-payment continues to escalate. It can file another rate case. We conclude that the better approach is to ensure that Nicor is sufficiently motivated to collect from those who incur past due bills from those ratepayers, and not the ratepayers who pay their bills.

We additionally note that, in Nicor's last rate case, it made a similar proposal, which was rejected. We acknowledge that the economic times, now, are different from those that existed when we entertained Nicor's last rate case. However, the difficult economic times have an impact upon all American citizens and all American businesses. Nicor articulates no reason why we should impose the cost of its uncollectible expense upon its customers that pay their gas bills, but, who are, nevertheless, also feeling the impact of a bad economy. Even Nicor acknowledges that the factors creating its current amount of uncollectible accounts are beyond the control of its ratepayers.

Further, as we noted in Section V(C)(2) herein, Nicor has pursued an aggressive program to timely collect the payment that is due it. Some of these programs, however, are newly-implemented. Nicor may incur additional benefits from these programs as time progresses. And, as was also set forth in Section V(C)(2) herein, Nicor's rate of recovery of its Uncollectible Accounts Expense has been increased herein, from 1.4% to 2.02%. This, also, should provide Nicor with some relief from the amount of uncollectible accounts it currently is encountering.

Because we conclude that imposition of this Rider is not warranted, we need not consider the AG's legal arguments.

3. Rider 27 – Company Use Adjustment

Nicor proposed Rider CUA which provides for timely recovery of gas price changes in the cost of natural gas it uses in the normal course of its business operations. The AG argued that Nicor's proposed automatic rate adjustment for company use of gas should be rejected.

a. Nicor's Position

Nicor stated that like Rider UEA, Rider CUA addresses year-to-year volatility in the market price of natural gas, as, according to Nicor, this volatility has had a substantially negative impact on its opportunity to recover its Commission-approved gas-related costs because the level of Company Use expense is driven by natural gas prices. Nicor contended that the volatility of natural gas prices means that the level of Company Use expense for the test year will probably not predict the level of Company Use expense that will be experienced in subsequent years. Nicor Initial Brief at 103-104.

Nicor averred that for purposes of Rider CUA, Company Use gas is the gas that it consumes in the provision of its natural gas distribution service to customers, which includes gas: (1) used to run the compressor units at storage fields; (2) consumed in the operation of the storage fields (other than compressor fuel); and (3) used in Nicor's buildings and other operating facilities. Respectively, these components represent approximately (1) 38% of the test year Company Use volume, or $10.1 million in costs, (2) 56% of the test year Company Use volume, or $15.1 million in costs, and (3) 6% of the test year Company Use volume, or $1.6 million in costs. Nicor Ex. 14.0 at 40.

Rider CUA starts with a Commission-approved baseline for Company Use gas expense, which is premised on a specific volume of gas use at a particular price. The proposed rider addresses only the volatility in price, as, Nicor demonstrated that its historical volume of usage is consistent. Nicor contended that Rider CUA would permit it to recover from customers only its actual annual costs for Company Use gas. It would allow Nicor to recover or refund the difference in expenses caused by the difference between the actual average gas price and the price included in its Commission-approved base rates. Nicor Ex. 12.0 at 16-17.

Annually, Nicor would calculate the impact that gas price changes have had on the cost of Company Use gas. In determining the amount of the charge or refund, Rider CUA would multiply the actual average price of natural gas for the year by the number of therms approved in this case to establish "total cost," which would then be compared to the amount approved in this case. The difference is then recovered or refunded through Rider CUA. Rider CUA would apply to all rate classifications except Rates 17, 19 and 21.

Nicor asserted that Rider CUA is needed at this time because an accounting change in the 2004 Rate Case removed a significant portion of this cost (for gas storage losses) from its gas supply cost recovery rider (Rider 6) and placed it into base rates. According to Nicor, this change significantly increased its exposure to gas price volatility because it removes Nicor's effective monthly recovery of the cost under Rider 6. The cost is now recovered at the 2004 Rate Case test year cost level. Nicor Ex. 14.0 at 38-39.

Under Rider CUA, Nicor proposed to recover or refund an appropriate amount per therm, during April through December, to the applicable service classifications based upon: (1) the prior year's actual average cost per therm of Company Use gas; (2) the rate case level of Company Use therms; and (3) the cost of Company Use gas included in Nicor's most recent rate case.

Nicor will conduct an annual reconciliation in which it will compare the actual dollar amounts charged or credited for the previous year and the amount intended to be charged or credited. Any difference between these respective amounts will be adjusted for interest at the rate established by the Commission under 83 Ill. Adm. Code § 280.70(e)(1). The resulting reconciliation factors will be included in the rates, filed by March 20th of each year, and effective April 1st through December 30th of the following year.

Nicor agreed to the four changes recommended by Staff for adoption, if Rider CUA is approved. The changes are: (1) an annual docketed reconciliation proceeding that includes a Factor O for Commission ordered adjustments in the tariff formula; (2) a prudency and reasonableness of costs determination in such a reconciliation proceeding; (3) an annual internal audit with specific tests; and (4) certain other corrections to the tariff proposed by Nicor. In addition, Nicor agreed to only use the test-year forecasted volume from the most recent rate case.

Nicor stated that Rider CUA provides it with a reasonable opportunity to recover its actual Company Use costs because it only applies to changes in gas prices and not to changes in volumes of Company Use gas consumed. It also creates a strong incentive for it to do all it can to manage those volumes effectively. Further, Rider CUA benefits Nicor's customers by providing a reduction in their bills, if gas prices fall below the gas price used to calculate the amount of Company Use expense included in base rates.

b. The AG/CUB Position

AG/CUB maintained that Nicor proposed Rider CUA to recover changes in the cost of gas that it uses for internal purposes. Its proposal would allow it to automatically recover changes in Account 819 – Compressor station fuel and power; Account 823 – Gas Losses; and the portion of Account 932 (Maintenance of general plant) that represent gas costs for Company facilities. AG Initial Brief at 43-44. AG/CUB argued that through Rider CUA, Nicor is asking that its customers bear all risks associated with changes in natural gas prices, including the gas that it uses for fuel in its compressors and office buildings.

AG/CUB witness Mr. Rubin stated that for internal purposes, (Accounts 819 and 932) Nicor is no different from any other customer. Every customer must make decisions about how to respond to changes in prices. Mr. Rubin maintained that Nicor has the opportunity to respond to price changes, and if it decides not to, then, higher energy costs may reduce its profitability. AG/CUB Ex. 2.0 at 17; AG Initial Brief at 44-45. AG/CUB argued that Nicor should not be permitted to automatically pass along its higher costs to consumers. If it were permitted to do so, it would have no incentive to control these costs and make the types of decisions that every other customer must make when energy prices increase.

AG/CUB noted that the Commission has previously rejected a similar proposal by Nicor. In Nicor's last rate case, it asked to recover its costs in Account 823 through Rider 6 (Gas Cost Adjustment). The Commission rejected this proposal and specifically found that the Commission's accounting rules classify lost gas as an operating and maintenance expense and, as such, it must be recovered through base rates. Nicor Rate Case Order, Docket 04-0779 at 39-40; AG Initial Brief at 45.

AG/CUB stated that one of the criteria for determining whether an automatic adjustment mechanism is appropriate is the volatility of the expense. AG/CUB maintained that Nicor's level of consumption and costs in these accounts have not fluctuated substantially from year to year, with the exception of 2006. AG/CUB Exhibit 2.02 shows Nicor's level of consumption and cost in each of these accounts for 2005 through 2007, and compares it to Nicor's projected amounts for the test year. That exhibit shows that the actual cost per therm in 2005 and 2007 was essentially identical. The projected cost for the base period (2009) is also nearly the same as the cost per therm incurred by Nicor in those two years. The only aberration was in 2006, when gas costs were higher than normal. AG/CUB Ex. 2.06; AG Initial Brief at 45.

AG/CUB argued that there are a couple of alternatives to rider recovery of Company Use gas that Nicor has available to it, should consumption in these accounts become unusual. First, if Nicor's management is of the opinion that it is not able to recover its costs, it could file for a base rate increase. In addition, AG/CUB witness Mr. Rubin pointed out that the Commission's accounting rules would permit Nicor to request an amortization, if the costs in Account 823 (gas losses from storage) were to change significantly. AG Initial Brief at 46.

AG/CUB also argued that, instead of considering costs and earnings in the aggregate, where potential changes in one or more items of expense or revenue may be offset by increases or decreases in other such items, Nicor's Rider CUA proposal considers changes in Company Use gas costs in isolation, ignoring the totality of circumstances and thereby constituting illegal single-issue ratemaking. If enacted, Rider CUA would violate the Act's prohibition against single-issue ratemaking by imposing a surcharge or a credit each month on customers' bills based on this difference in Company use gas costs, without examining whether Nicor's cost of service and revenue requirement have increased. AG Initial Brief at 51.

AG/CUB further contended that Rider CUA violates the Act's prohibition against retroactive ratemaking. Section 9-201 of the Act ensures that rates for utility service are set prospectively. 220 ILCS 5/ 9-201. The Illinois Supreme Court has held repeatedly that the Act does not permit retroactive ratemaking; that is, once the Commission establishes rates, the Act does not permit refunds if the established rates are too high, or surcharges if the rates are too low. *Citizens Utilities Co. v. Illinois Commerce Comm.,* 124 Ill. 2d 195, 207; 529 N.E.2d 510 (1988). According to the AG, Nicor's proposed Rider CUA violates the prohibition in the Act against retroactive ratemaking by enacting changes in rates outside of the ratemaking process. These retroactive bill adjustments are illegal under the aforementioned Illinois Supreme Court rulings that prohibit retroactive ratemaking. In establishing the rule prohibiting retroactive ratemaking, the Illinois Supreme Court noted that retroactive adjustments add a degree of uncertainty to the ratemaking process. *Citizens Utilities,* 124 Ill. 2d at 207. Rider CUA's monthly adjustments related to Company Use gas would, according to the AG, add an unnecessary degree of uncertainty and volatility to customer bills. AG Initial Brief at 51-52.

AG/CUB maintained that Rider CUA's recovery of additional revenues for Company Use gas beyond those approved in this rate order violates the Commission's test year rules. AG/CUB also proffered that Rider CUA violates the Commission's and Illinois law's test-year principles by selecting only one component of the revenue requirement, which in this case is Company Use gas, tracking changes in that revenue requirement component and then assessing rate adjustments to recognize this change on a single-issue basis. AG Initial Brief at 52-53.

c. Staff's Position

Staff recommended that the Commission reject Rider CUA. Staff's concern with Rider CUA are: (i) whether the volatility of natural gas prices causes Company Use gas costs to rise to a level that justifies recovery through a Rider; (ii) whether lost and unaccounted for gas storage losses are being measured properly and whether any incorrect measurement leads to improper financial accounting; and (iii) whether proposed Rider CUA adversely affects Nicor's incentive to seek new business practices or incorporate new equipment that reduce the usage of natural gas and reduce its exposure to price volatility. Staff Ex. 13.0 at 22-23, 26-27.

Staff argued that Nicor is proposing Rider CUA to adjust customer bills based on the costs for gas it uses that is recorded in Uniform System of Accounts ("USOA") in Accounts 819, 823, and 932. Company Use gas is broadly categorized as compressor fuel, gas storage losses, and gas used at company facilities. Nicor's test-year forecast estimates Company Use gas at 3,943,600 MMBtu, of which 3,080,300 MMBtu are relevant to Rider CUA. Staff Ex. 13.0 at 19. The test-year forecasted costs for these 3,080,300 MMBtu are approximately $26.8 million. Nicor contends that a $1 per MMBtu change in the price of natural gas changes Company Use costs by approximately $3.1 million. Based on the impact of this price volatility, Nicor is proposing to credit or charge its customers for per therm deviations between the annual average price and the test-year forecasted price of natural gas. Staff Initial Brief at 146-47.

The proposed rider would affect Sales customers on Rates 1, 4, 5, 6, and 7 and Transportation customers on Rates 74, 75, 76 and 77, and Riders 15 and 25. Nicor Ex. 14 at 40. Under the proposed rider, Sales and Transportation customers would receive different credits or charges due to differences in the accounting for lost and accounted for gas. The difference in charges or credits between Sales and Transportation customers results because lost gas from Account 823 is accounted for differently. Transportation customers pay for lost gas in kind, while Sales customers pay for lost gas through base rates. Staff Initial Brief at 147.

Staff did not concur that Company Use gas costs are significant enough to justify rider recovery and has concerns with the Coefficient of Variation ("CV") analysis that Nicor performs to determine that these costs are volatile. Nicor's witnesses testified that a $1 per MMBtu change in the price of natural gas leads to approximately a $3.1 million change in Company Use gas costs. This $3.1 million dollar estimate includes lost and unaccounted for gas from Account 823, which the Commission removed from Rider 6 in Nicor's 2004 rate case. Nicor Rate Case Order, Docket 04-0779, at 39-40. Staff believed that the Commission should remain consistent with its 2004 decision by keeping Account 823 costs in the rate base. Staff Ex 25.0 at 2-3.

Staff pointed out that Nicor only briefly acknowledges the 2004 ruling. The acknowledgement is limited to a reference to an accounting change that increased gas price volatility from moving a significant portion of the costs from Rider 6 to Account 823. *See* Nicor Ex. 14.0 at 39. However, it made no reference to the Commission's decision that "the Company's proposal appears to be in direct violation of a Commission rule, Part 505, and the Commission can not allow this to continue." Nicor Rate Case Order, Docket 04-0779 at 40. Further, according to Staff, Nicor has provided no legal justification for the Commission to alter its previous ruling. Staff Initial Brief at 149.

The gas volume from Account 823 is 56% of total company use. Staff stated that, if the Commission is consistent with its 2004 ruling and the costs associated with Account 823 are excluded from the analysis, then, approximately 56% of the volumes that Nicor seeks to recover through Rider CUA should be excluded. The costs associated with these volumes could be amortized, with Commission approval, if there were significant costs increases. Nicor Rate Case Order, Docket 04-0779, at 39-40; Staff Initial Brief at 149-50.

Staff maintained that exclusion of the 56% of volumes in Account 823 leads to about a $1.36 million change in Company Use expenses in Accounts 819 and 932 for each $1 per MMBtu change in the price of natural gas. This $1.36 million change in costs amounts to only 0.088% of test-year forecasted original cost rate base and only about 0.96% of test-year forecasted operating income. Company Use gas costs are not significant by either comparison. Staff Initial Brief at 150.

Staff had three objections to Nicor's CV analysis which was provided in Nicor Ex. 46.1. Nicor excludes lost and unaccounted for gas for the years 2000-2004 from this analysis. Lost and unaccounted for gas is measured during withdrawal from storage which occurs from November to April. Staff showed that prices are usually higher from November to April than they are from May to October. Staff Ex. 25.1. Thus, excluding lost and unaccounted for gas from the analysis will affect both the mean and the standard deviation used to determine the value of CV. Staff Initial Brief at 150.

Second, the CV analysis performed in Nicor Ex. 46.1 indicates a mean price of $6.19 per MMBtu for the years 2000-2007. The test-year forecasted Company Use gas cost was not based on this price. It was based on a three-day average of the New York Mercantile Exchange futures prices for each month of the test-year. Staff witness Dr. Brightwell calculated the Company Use gas cost test-year weighted average price as approximately $8.70 per MMBtu. Staff Ex. 25.0 at 5. To the extent that there is price volatility, it is mitigated by using a test-year forecast price that is $2.50 above the mean price determined in Nicor's CV analysis. Staff Initial Brief at 150-51.

Finally, Staff opined that the CV analysis can determine that some costs are more volatile than others, but, it can not conclusively determine any particular cost is volatile in an absolute sense. Staff averred that Nicor argues that the CV indicates that gas prices are nearly five times more volatile than other Operating and Maintenance Expenses. However, this does not conclusively indicate that gas prices are volatile. It only indicates that gas prices are more volatile than non-commodity Operating and Maintenance Expenses. Staff concluded that therefore, the Commission should conclude that Nicor has not met the burden of proof necessary to authorize recovery of these costs through Rider CUA. Staff Initial Brief at 151.

Staff also argued that Rider CUA reduces incentives to conserve gas by mitigating the impact of price changes and transferring risk. Nicor argues that Rider CUA does not remove an incentive to manage Company Use costs effectively because it limits recovery to no more than the test-year forecasted volumes. Staff maintained that there is a fundamental difference between having an incentive to use no more than a specified quantity of gas and having an incentive to reduce usage. A rider mechanism degrades the incentive to reduce usage. Staff Ex. 13.0 at 27. Both high prices and the risks associated with price uncertainty provide an incentive to reduce gas usage. Staff Initial Brief at 151.

d. Analysis and Conclusions

The Commission finds that Nicor's proposed automatic rate adjustment for Company Use of gas should be rejected. Nicor is asking that its customers bear all risks associated with changes in natural gas prices. We find that this does not justify recovering this cost through a rider where Nicor would basically be permitted to automatically pass along its higher costs to its consumers. We agree with AG/CUB and Staff that, if Nicor were permitted to pass along these higher costs, then it would have no incentive to control these costs and make the types of decisions that every other customer must make when energy prices increase. We further agree that there are alternatives to rider recovery of Company Use gas that Nicor has available to it, including filing for a base rate increase and requesting an amortization.

The Commission finds that Rider CUA does not present the appropriate means of addressing the year-to-year volatility in the market price of natural gas.

4. Rider 29 – Energy Efficiency Plan (the "EEP")

a. Whether to Adopt Rider 29

Nicor asserted that, similar to the energy efficiency program approved in the 2007 Peoples Gas Rate Case, Rider EEP is intended to allow it to propose and support a funding mechanism for energy efficiency programs that it will offer to its consumers. Rider EEP would permit Nicor to compute, on an annual basis, a monthly charge per customer for the applicable service classifications so that Nicor may recover its expenses from the development and implementation of the Plan. Nicor proposed to implement Rider EEP on a pilot basis for a four-year period. Nicor Initial Brief at 113.

Nicor agreed to accept seven changes to Rider EEP that Staff posed, in the event that the Commission determines the rider is appropriate. These changes are to: (1) correct the dates associated with the filing date of the Effective Component; (2) to correct the date of the first Reconciliation Period; (3) to correct the definition of the Carry Over Percentage; (4) to incorporate the suggested revision of the Effective Component formula for the first Plan Period of less than 12 calendar months; (5) to enhance the description of the RA2 component of the Reconciliation Adjustment formula; (6) to revise the Reconciliation Adjustment formula to allow a Factor O; and (7) to insert language in Rider EEP requiring Nicor to add an annual internal audit report requirement, with Staff's specified tests. Nicor Initial Brief at 115.

The ELPC and the AG recommend approving Nicor's program. Staff, however, argued that it is not needed and it should be disapproved.

i. Nicor's Position

Nicor averred that there are two components to its proposed Rider EEP, the Effective Component and the Reconciliation Adjustment. The Effective Component is a monthly charge, which is derived from the amount budgeted for the plan. The Reconciliation Adjustment is an annual correction to the Effective Component based on any over-collection or under-collection of Nicor's actual expenses. The Effective Component is allocated to the customer service classes that are targeted by the program. Each class would pay for the portion of the annual plan budget that is targeted to energy efficiency in its rate class, along with an adjustment for program-induced usage reductions. Mr. O'Connor testified, however, that if the Commission were to approve Rider 28, Nicor's Volume-Balancing Adjustment, Nicor would not need to adjust here for any program-induced usage reductions. Nicor Ex. 12.0 at 27.

According to Nicor, a per customer per month charge for each applicable service classification will be calculated each December, to be effective for the next year, based upon the Energy Efficiency Plan budget for the upcoming year, divided by forecasted average numbers of customers for the same period (the "Effective Component") and converted to a per month charge. A filing, which will be made with the Commission each April, will include a reconciliation of the previous year's expenses, any "carry-over" dollars and revenues arising from the Effective Component of Rider EEP, as well as recognition of any prior year reconciliation adjustments. Because budgeted funds may not be fully expended initially, Nicor proposed to "carry over" up to 75%, 50% and 25% of budget dollars into the second, third and fourth years of the program, respectively. Finally, Nicor proposed to carry over up to 10% of budget dollars in year five and thereafter, if the pilot program is extended beyond its initial term. Nicor Ex. 14.0 at 48.

The Annual Plan Budget is the total annual budget, which is, $13 million, or a lesser amount, as is approved by the Commission. 70% of these funds will be allocated to Rate 1 (Residential Service) and 30% to the non-residential Rates 4 and 74 service classifications. If the Commission were to approve a lesser amount, Nicor would still allocate the lesser amount in the same proportions. Nicor Initial Brief at 117-18.

Nicor does not agree with the ELPC's proposal to increase the funding for Rider EEP. Nicor opined that, because this is a four-year pilot plan, the proposed $13 million cap is sufficient to provide a broad range of energy efficiency services to its residential and small commercial customers. Rather, future market studies and the results of Nicor's EEP can provide the requisite basis to determine funding levels in the future. Nicor pointed out that the ELPC averred that it would be content with a consistent stable funding level of $15 million a year. Also, according to Nicor, the ELPC conceded that it would be difficult to arrive at a definitive funding level or dollar figure until a formal study of Nicor's service territory is performed. *Id.* at 118; Tr. at 155.

While the ELPC's testimony establishes the compelling value for using ratepayer funds to promote energy efficiency, Nicor does not agree with the ELPC's proposal that the Commission set the Plan's energy use reduction goals at this point in time. The ELPC suggested that the Commission set a specific natural gas reduction goal, with a means of gradually "ramping up" that goal over the four-year pilot period. This proposal should be rejected, Nicor maintained, because reduced consumption levels have not been tied to specific funding levels. Also, it is not based upon a market study of Nicor's service territory. Nicor Initial Brief at 117.

Nicor asserted that its proposed EEP Plan allows for specific programs to be developed by a Plan Administrator in conjunction with an Advisory Board. Nicor envisioned considering the same types of programs as that which were described in the Peoples Gas Energy Efficiency Plan, which include, among other things, rebates to provide incentives for customers to purchase or install more energy efficient technology, including boilers, steam traps, HVAC technology, and like products. Also, Nicor will have direct customer programs, such as, offering direct installation of free or low-cost energy efficiency measures for residential customers, such as low-flow showerheads, water heater wraps and like items. Nicor also would include programs targeted at low-income customers, such as weatherization measure installations, furnace replacement, and like items. Programs could also be structured as 'shared savings financing,' where a customer pays for the cost of the energy efficiency installation through savings from the project with a low-interest loan. It further envisioned that it will have market transformation programs that focus on developing and providing information to educate a wide variety of program participants, like homeowners, businesses, vendors, contractors, as to the available energy efficiency options and best practices. Nicor Ex. 13.0 at 6-13.

Nicor estimates a breakdown of program spending as follows:

	Residential	Business
Incentives and Rebates	50-60%	40-50%
Marketing/promotion	10-15%	5-10%
Implementation	20-30%	35-45%
Administration	5%	5%

Evaluation	3%	3%

Id. at 15.

Nicor also proposed to have a third-party review process designed to assess how well the overall structure and process of the programs are performing, and whether changes should be implemented to enhance the administration and performance of the programs. This would include an evaluation of whether plan expenditures are benefiting Nicor's customers, and not end-users that reside outside of Nicor's service territory. Such a review would take place 24 months after Commission approval of the programs proposed.

Nicor additionally provided a general list of anticipated reports to be filed as needed, such as on a quarterly or semi-annual basis, as well an annual report, irrespective of need which would include the following information:

(1) Impact results of the programs in terms of therms saved, customers served, and dollars spent as compared to budget;
(2) a benefit/cost analysis of both the Plan and its programs;
(3) a comparison of results to estimated potential;
(4) the market transformation effects;
(5) any economic and economic development impacts;
(6) the environmental impacts (emissions);
(7) any non-energy benefits; and
(8) process and impact evaluations, by program and sector.

Nicor Ex. 13.0 at 17. Nicor further asserted that the accuracy of energy savings will be tested annually by comparing two calculations, which are, the system-wide comparison of the actual, versus forecasted, throughput, and the per-program savings approved by Nicor's Advisory Board. Nicor Ex. 47.0 at 4-5.

On exceptions, Nicor contends that a modification of Rider EEP would be needed if Rider VBA is approved, as currently, Rider EEP contains a Conservation Stabilization Adjustment ("CSA") that provides for the recovery of lost revenues associated with the deemed natural gas energy savings outlined in the Plan. Nicor Brief on Exceptions, Attachment A, at 191. Nicor argues that this Commission should rule that the CSA is approved in the future for when Rider VBA is not in effect. The CSA allows Nicor to recover revenues that are lost due to therm reductions resulting from those energy efficiency programs approved and implemented by the Advisory Board. The Advisory Board would approve the programs and provide Nicor with the level of therm reduction attributable to residential and non-residential customers using the various programs. Nicor would multiply those therm levels by the last distribution block charge for the respective rate class to determine the amount of lost revenue. The lost revenue would be included as a cost in the annual Rider EEP charge and be recovered from customers. *Id.*

ii. The ELPC's Position

ELPC's witness, Mr. Kubert, testified that the average wholesale price of natural gas has recently been between $9.00 and $12 per thousand cubic feet (Mcf). According to Mr. Kubert, properly-designed energy efficiency programs can save natural gas at a life cycle cost which is one-third of the cost of purchasing and distributing this same amount. He averred that all ratepayers benefit from energy efficiency programs because utilities are able to buy less natural gas on the margin, when gas is most expensive, which reduces demand during seasonal peak periods. At current gas prices, each 1% reduction in gas consumption represents $22 million annually in avoided gas costs and interstate distribution expenses. ELPC Ex. 1.0 at 5.

The ELPC disagreed with Staff witness Dr. Brightwell's recommendation that Nicor's EEP should not be approved. While consumers may be conserving on their own, according to the ELPC, this conservation hardly solves the problem of dramatic gas bill increases. The ELPC averred that in the last five years, the average expenditure on heating in the Midwest has gone from $750 to $1008 per year.

The ELPC asserted that there is a difference between conservation and energy efficiency. The decline in demand for natural gas, according to the ELPC's witness Mr. Kubert, may be due to customers simply lowering their thermostats and living less comfortably in order to save on their gas bills. However, there is no evidence that Nicor's customers are making real, permanent changes in their energy consumption through investments in energy efficient products. ELPC Initial Brief at 9-10.

The ELPC is of the opinion that Nicor's proposed funding level, $13 million per year, is too low. This figure arose from the amount of a settlement (at $7.5 million) in the Peoples Gas Merger case, Docket 06-0540, and, also, the level of funding for the Ameren natural gas energy efficiency program. The ELPC's witness Mr. Kubert opined that the funding should increase to the level it is for the natural gas energy efficiency programs in our neighboring states, Iowa, Wisconsin and Minnesota. He proposed to gradually increase the level of funding to $25 million annually. ELPC Initial Brief at 7.

However, if the Commission disagrees with the proposal to increase funding to $25 million, the ELPC proposed an alternative in the amount of $15 million annually. This $15 million is based upon the fact that Nicor serves approximately twice as many customers as Peoples Gas serves. Also, its overall gas sales are approximately 2.07 times that of Peoples Gas. The ELPC reasoned that therefore, Nicor's level of funding should be double that of Peoples Gas ($7.5 million). The ELPC further recommended that the Commission should commit to a proceeding to review the funding level of this program after the second year of the program. *Id.*

The ELPC recommended that this Commission set energy savings targets for Nicor to meet during the course of the program. Mr. Kubert recommended setting the targets at 0.25% for the first year, 0.5% for the second year, 0.75% for the third year and 1% for the fourth year. He noted that Minnesota has a law that requires gas utilities to achieve 1.5% in annual savings. He concluded that 1% savings, therefore, should be achievable. *Id.* at 7-9.

iii. The AG's Position

The AG supported implementing Nicor's Energy Efficiency Program. The AG contended that such programs create a permanent change in the actual consumption of natural gas. According to the AG, improving energy efficiency has long-term, positive impacts on a customer's natural gas bill without a decrease in that customer's comfort-level. Because energy efficiency plans reduce gas usage and lower gas bills, they are also beneficial to the larger Illinois community. AG Initial Brief at 75.

The AG disagreed with Staff witness Dr. Brightwell's contention that Nicor's Energy Efficiency Plan should not be approved. Citing the transcripts from trial, the AG averred that Dr. Brightwell admitted that he had not performed any analysis to determine the reason why Nicor's customers are using less natural gas. Also, he did not examine energy efficiency programs in other states. The AG further maintained that Dr. Brightwell admitted that he had no analysis to support his position that, if gas prices are expected to remain high, many energy efficiency projects could become economically viable because the lifetime energy savings would then be sufficient to cover the upfront costs of implementing energy efficiency measures. *See,* Tr. 548-89, 566, 578-579.

The AG is of the opinion that the Commission should reject Nicor's proposed Conservation Stabilization Adjustment to Rider EEP. The AG averred that it is unreasonable to recover lost revenues through an automatic rate adjustment because, according to the AG, if usage reductions result from energy efficiency programs, it would be reasonable to reflect those changes in a rate case. The AG further contended that Nicor can not yet provide either a description of the programs it expects to implement, or anticipated declines and revenue losses associated with any such programs, since they have yet to be created. The AG pointed out that Illinois' electric delivery service providers are required to offer energy efficiency programs, but, they are not compensated in any way for revenue losses attributable to such programs, citing 220 ILCS 5/8-103(e). AG Initial Brief at 76-77.

The AG, however, shared Staff's concerns that savings from the program must be measured as accurately as possible. The AG submitted that the deemed value approach proposed by Nicor is something that the Commission should carefully consider. Also, savings targets should be set. Until the program funding levels are known, and until Nicor's Advisory Board can consider the matter, the AG suggested that the Commission direct that annual savings goals, including a measurement of cost-effectiveness such as the Total Resource Cost Test, should be one of the first priorities of the Advisory Board. [25] Also, if deemed savings are to be used, they should be used only as an initial planning tool, and the Advisory Board should, as part of its evaluation plan, address how deemed savings can, over time, be replaced by more accurate measurements. AG Reply Brief at 54.

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[25] As the AG noted, the Total Resource Cost Test, or "TRC" test, was discussed in the electric utilities' energy efficiency dockets, Dockets No. 07-0539 and 07-0540. It is an industry-standard measurement of the cost-effectiveness of measures in energy efficiency plans.

iv. Staff's Position

Staff witness Dr. Brightwell opined that an Energy Efficiency Plan is not necessary. In his opinion, while energy conservation is a desirable goal, high natural gas prices, as well as the uncertainty about future natural gas prices, provides customers with a strong incentive to privately adopt conservation measures. He pointed out that Nicor projects that its residential customers will use 8% less natural gas in the test year than they did in 2004. Dr. Brightwell posited that this projection establishes that Nicor's customers are doing things on their own to conserve natural gas consumption. He opined that when the price of natural gas is high, there is a heightened degree of awareness about costs. Thus, efforts naturally take place to mitigate those costs. He concluded that many of Nicor's customers are already seeking ways to conserve gas. And, if customers expect gas prices to remain high, many energy efficiency projects become economically viable. Staff Ex. 13.0 at 6, 8.

Dr. Brightwell also maintained that a problem with "free riders" would cause much of the energy efficiency funds to be wasted. "Free riders" are consumers who would have purchased the energy efficient item, regardless of whether an energy efficiency program exists. Those consumers use energy efficiency plan funds to help pay the costs of projects that they would have undertaken anyway, regardless of the existence of an energy efficiency program. According to Dr. Brightwell, any dollar that is provided to a free rider is wasted. Staff Ex. 13.0 at 7-8.

Dr. Brightwell acknowledged that the average residential consumption of natural gas has always been much higher in Illinois than in neighboring states that have natural gas energy efficiency programs, specifically, Iowa, Wisconsin and Minnesota; yet, he averred that state-wide, the decline on the part of Illinois consumers in natural gas usage is greater than that of these other states. He stated, however, that the price of natural gas in these three other states has not diminished during the time period between 1996 and 2006. *Id.* at 10-12.

Staff averred that Figure 2 of Staff witness Brightwell's testimony, Staff Ex 13.0 at 12, indicates that between 1996 and 2006, per residential customer natural gas use declined by approximately 2.9% in Illinois, 3.3% in Iowa, 3.2% in Minnesota, and 3.0% in Wisconsin. Staff cited the ELPC witness Mr. Kubert, who calculated that "[a]t current gas prices, each 1% reduction in gas consumption from residential and commercial customers represents $22 million annually in avoided gas and interstate distribution expenses." The most successful of these programs (Iowa) yields a 0.4 percentage point incremental reduction over what is occurring in Illinois, which is, 3.3% versus 2.9%, Staff averred that therefore, an expenditure of $13 million annually would result in approximate annual savings of $4.6 million, with a net annual loss to ratepayers of $8.4 million. Staff Initial Brief at 159-60.

Staff further opined that proponents of Nicor's EEP could argue that this analysis is flawed because savings of $4.6 million occur in each of several years, not just in the year in which the investment took place. However, Staff continued, the 0.4 percentage point additional reduction in Iowa over Illinois is the result of at least eleven years of energy efficiency program investments, not just the investments that would occur in one year. From this perspective, the cumulative cost associated with obtaining a $4.6 million annual savings is much greater than $13 million associated with one program year.

Staff further asserted that Nicor has provided no evidence establishing that Rider EEP is cost-effective. Staff cited Nicor witness Ms. Nichols, who testified that, in fact, Nicor has not performed or commissioned any studies to evaluate the need for this program. Staff Initial Brief at 158.

If Nicor's EEP program is not rejected, Staff further recommended that the Commission consider reducing the amount of funding for Rider EEP, in order to evaluate the overall effectiveness of the program before expanding it or disbanding it. The Commission could also postpone judgment about whether to adopt a program in Nicor's territory until it receives information about the effectiveness of the Peoples Gas EEP and the Ameren EEP to determine which structure performs better, or if an energy efficiency program is even worth continuing under either structure. Staff Initial Brief at 157.

v. Analysis and Conclusions

Since Rider VBA is denied pursuant to this Order, we need not decide whether it is proper for Nicor to implement an adjustment for program-induced usage reductions (its "CSA"). Nicor shall, therefore, remove any language from Rider 29 imposing such an adjustment. It shall do so and re-file the appropriate tariff(s) within three days of the date of a final Order in this docket. We further note that Nicor has presented no legal or factual evidence indicating that it is appropriate to adjust for program-induced usage reductions. Therefore, Nicor's request to adjust its rates for the energy savings that consumers may incur as a result of this program is denied. Moreover, it appears that recovery of lost revenue, without more, in a rider, could be illegal. *A. Finkl & Sons Co. v. Illinois Commerce Comm,* 250 Ill. App. 3d 317, 620 N.E.2d 1141 (1st Dist. 1993).

However, we disagree with Staff's contention that Nicor's Energy Efficiency Rider should not be approved. Dr. Brightwell provides no factual support for his factual conclusion that consumers will be able to install energy efficiency measures simply because they wish to mitigate high natural gas prices. We note that he provides us with no studies or other factual bases for this factual conclusion.

Also, Dr. Brightwell does not take into account that one of the real benefits of energy efficiency programs is education. It may very well be true that, as he asserted, high prices produce a natural proneness, on the part of persons and businesses, to mitigate those costs. But this does not mean that all consumers will educate themselves as to how to effectively mitigate the cost of natural gas. It also does not mean that all consumers will be adequately, and accurately, informed on the subject. Some consumers may not know how to install or implement an energy efficiency measure or where to purchase such a product. A well-designed energy efficiency program provides an accurate and adequate source of such information. Also, Dr. Brightwell does not take into account that some people simply can not afford energy efficiency measures. Indeed, some energy efficiency measures, such as, the installation of energy efficient furnaces, can be very costly.

And, while statistically, Illinoisans may be declining in their use of natural gas at a greater rate than our counterparts in Iowa, Minnesota and Wisconsin, Dr. Brightwell's chart (Staff Ex. 13.0 at 12) shows that Illinoisans have a much higher place to fall from than our neighbors in these three states, some of which suffer colder winters than that which we experience in Illinois. Dr. Brightwell's chart establishes that Illinoisans clearly consume considerably more natural gas than some of our neighbors. In 2006, the average residential customer in Iowa consumed 72.002 Mcf of natural gas. The average residential customer in Minnesota consumed 83.599.119 Mcf of natural gas. The average residential customer in Wisconsin consumed 74.804 Mcf of natural gas. The average Illinoisan, however, consumed 104.464 Mcf of natural gas. The average Iowan and the average resident of Wisconsin consume approximately 25% less natural gas than the average Illinoisan. This difference is not a small one.

We also agree with the ELPC's assertion that, while gas consumption has declined in Nicor's service territory, this does not mean that Nicor's customers are using energy efficient products to achieve this decline. Other factors, such as warmer winters, or, as Mr. Kubert mentioned, simply turning a thermostat down, may very well account for all or at least a part of the decline in customer usage of natural gas. This is true because there really is no evidence that Nicor's customers are currently using energy efficient products.

We additionally note that energy efficiency programs, in addition to aiding individual consumers in reducing their gas bills, reduce the overall demand for natural gas, which aids in keeping the price of natural gas down, as typically once the demand for a product or commodity decreases, so does its price. Energy efficiency programs also reduce the amount of energy needed during peak times when natural gas is the most expensive. Further, as was noted elsewhere herein, some energy efficiency measures (*e.g.,* insulation) reduce both natural gas consumption and electric consumption. Consumers who participate in Nicor's proposed EEP and receive such dual-purpose energy efficiency measures will therefore further reduce their energy consumption and therefore their energy bills.

And, while Dr. Brightwell testified that energy efficiency funds will be wasted upon "free riders," he did not provide us with an indication as to how many "free riders" there typically are in an energy efficiency program. From his testimony, it is not possible to determine how much or how little of the energy efficiency funds would be diverted to "free riders." We note that the overall effect of reducing the demand for natural gas would still be achieved, even with "free riders" purchasing products through an energy efficiency program that they would have purchased anyway.

We also decline to wait until the Ameren Utilities' and Peoples Gas Energy Efficiency Plans are analyzed before allowing Nicor to implement such a plan. The better course of action is to allow more Illinoisans the opportunity to benefit from energy efficiency plans. Also, we will have the benefit of comparing Nicor's program with that of the Ameren and People Gas utilities.

Nicor's Rider EEP is, therefore, approved. However, we note that Staff, the AG and the ELPC have articulated legitimate concerns regarding the lack of structure that Nicor's proposal has, despite the laudable goal of reducing energy consumption.

Nicor proposes a $13 million budget but it does not state what energy efficiency goals can be attained with this budget. We acknowledge that energy savings can not be determined without knowing how much funding is to be allocated. However, the ratepayers should have some assurance that the energy savings goals developed by Nicor's Advisory Board are reasonable, ascertainable, and that they constitute the best use of the funds, based upon some standards. Moreover, the development of some standards for energy efficiency savings, correlated with the amount of money spent on energy efficiency would ensure that prudency reviews are adequate and also consistently applied to gas utilities.

Also, there are evaluation issues that remain regarding reconciliations of the energy efficiency funds. Staff has expressed the opinion that "free riders" will take advantage of Nicor's Energy Efficiency Plan and thereby skew any statistical results. The AG suggests that the Total Resource Cost test, which was discussed in the Commonwealth Edison and Ameren Energy Efficiency Dockets, Dockets 07-0539 and 07-0540, could alleviate the effect of any statistical skewering on the part of "free riders." There is also the question raised by the AG as to how long deemed energy savings values should be used.[26] Simply put, there is a difference of opinion as to what standards should be imposed on Nicor, except perhaps, with regard to glaringly inappropriate expenditures. We note that this is in contrast to electric energy efficiency programs, whereby such standards are statutorily imposed. *See,* 220 ILCS 5/8-103.

We conclude, therefore, that a rulemaking shall commence for the purpose of developing standards for natural gas Energy Efficiency Plans. In this way, the concerns expressed above can be addressed after a full vetting of what needs to be considered regarding these issues to produce a uniform, consistent, Commission approach to all natural gas-based energy efficiency plans. This also produces a certain level of certainty for the utilities as it will increase their knowledge of what to expect in such a proceeding.

On exceptions, Staff contends that developing a rule locks in current thinking and is therefore not productive. Staff Brief on Exceptions at 53. Staff acknowledges, though, that statutorily, there are standards in place for electric energy efficiency programs that do not exist for gas energy efficiency programs. Staff further states that the Commission Orders that approve natural gas energy efficiency programs do not impose savings targets upon gas utilities and they do not impose financial penalties upon gas utilities for failure to meet required savings levels. *Id.* at 54.

While we agree with Staff that no financial penalties should be imposed upon utilities for failure to meet energy savings targets, the fact is that there must be some

[26] "Deemed values" are values used for statistical analysis that are taken from the results of other states' energy efficiency analysis. They are used to determine the effectiveness of an Energy Efficiency Plan.

measure of prudence when a reconciliation proceeding is conducted in an energy efficiency docket. There is a difference between a financial penalty, which in legal parlance is akin to a fine, and a finding of imprudence, which disallows certain items.

We conclude that the measure of prudence should be against a reasonable standard, which ensures that energy efficiency dollars are wisely spent, as well as advising utilities as to what to expect during a prudency review. We note that, unlike energy efficiency for electric utilities, there are no standards at all to determine whether energy efficiency dollars are spent in a meaningful or useful way. Given that Nicor seeks to spend $13 million on energy efficiency, there should be some method of ascertaining whether those dollars are not wasted and are in fact, well-spent.

Staff argues that in the electric energy efficiency dockets it was determined that a rule would lock in current thinking and therefore would be counter-productive. However, certain rules can be fashioned to be flexible. Some rules can simply be fashioned in more of what a lawyer would term to be a “civil code” fashion, which is general, as opposed to a rule that designates very specific behavior. And, these rules can be amended if the need arises. Unlike the situation with electric energy efficiency, there currently are no standards at all for gas energy efficiency prudency reviews. Consumers need standards which can be flexible depending upon how they are designed to ensure that their funds are spent in a manner that benefits them. Also, utilities need to know that what they spend will not be subject to an arbitrary prudency review.

We also conclude that the level of funding for this program should not be decreased, as Staff has proposed. The funding level proffered by Nicor is modest. As the ELPC has pointed out, it is much less than that of some of our neighboring states. Staff has made no showing that if we reduced the funding for this program it would be effective. By the same token, we decline to increase the level of funding beyond $13 million, annually. The ELPC has acknowledged that $15 million would suffice, as it represents twice the amount of funding for Peoples Gas’ Energy Efficiency Plan. However, $13 million is close to twice the level of funding for the Peoples Gas Plan ($7.5 million). There also is no evidence that without this extra $2 million Nicor’s Energy Efficiency Plan will be under-funded or ineffective. Further, if the level of funding proves to be too low to be effective, Nicor can petition this Commission for an increase. We therefore decline to adopt the ELPC’s recommendation to commence a proceeding to review the funding level of this program.

b. The Management Structure Proposed by Nicor

The infrastructure involved in the implementation of Nicor’s Energy Efficiency Plan is as follows: the creation of an Advisory Board; Plan Administrator Program “Implementers;” a Program Evaluator; a Board Facilitator and a Fiscal Agent. Also, an independent third-party would review and evaluate the work of the energy efficiency personnel. Nicor would act as the fiscal agent for the Board. Thus, the Board would make the decisions regarding developing and implementing the Plan and Nicor would write the checks to pay for those decisions, as the fiscal agent. In other words, the Board would bear the responsibility for any imprudent decisions, not Nicor. Therefore, if the Board were to approve an imprudent expenditure, that expenditure may not be subject to a prudence review and the ratepayers would not see a refund of the imprudent expenditure. *See, e.g.,* Nicor Ex. 28.0 at 2.

i. Nicor's Position

Nicor contended that it has limited experience in offering energy efficiency programs. Additionally, the same structure was approved for Peoples Gas. Also, Nicor's Energy Efficiency Plan is voluntary, unlike the electric Energy Efficiency Plans that were devised by Commonwealth Edison and the Ameren Utilities after the General Assembly enacted Section 12-103 of the Act, 220 ILCS 5/8-103. Nicor further asserted that the electric utilities' situation is different from its situation because the electrical utilities' energy efficiency programs do not become operational until long after a portfolio of programs is assembled, as after programs are identified there is another Commission proceeding wherein an electric utility's portfolio is considered. Nicor witness Ms. Nichols testified that if Nicor were to emulate the electric utilities' Energy Efficiency Plans, Nicor's program would be delayed by an additional heating season or until the winter of 2010. Nicor Ex. 28.0 at 3-4.

Nicor argued that energy conservation and efficiency are both laudable and essential goals; however, the very success of those goals leads to a direct and negative impact on its ability to recover its revenue requirement. This creates an inescapable conflict of interest. According to Nicor, its proposed Energy Efficiency Program is designed to place the decisions regarding what portfolio of programs would best serve Nicor's customers and service territory under the control of a qualified, experienced and independent board. Nicor further averred that because it is ceding control of its Energy Efficiency Program to the Advisory Board, it would be unfair to hold it accountable for the prudence of decisions made by that Board. Nicor Reply Brief at 111-12.

Nicor pointed out, however, that its proposal calls for an independent audit after 24 months. Also, it is within the Commission's authority to act to redress any problems with the program as it sees fit, upon its own motion. Nicor concluded that the Commission's authority, as well as ongoing audits, together with the independent structure of the Advisory Board, make it unnecessary to impose financial responsibility on it for the actions of the Advisory Board that are later deemed to be imprudent. *Id.* at 113.

ii. Staff's Position

Staff advised that this Commission should consider an alternative to Nicor's proposed management structure. Staff witness Dr. Brightwell submitted essentially that the structure proposed by Nicor leaves ratepayers with little recourse for imprudent decisions as Nicor would not be liable for the imprudence of its Advisory Board. Instead, he maintained the structure of the Board should be similar to that which was approved in the Commonwealth Edison and the Ameren Utilities' electric energy efficiency plans, whereby the companies retained control over the decisions, and the Advisory Board did what its name would imply; it merely advised the utility. By controlling the decisions, a utility subjects its decisions to a prudence review. *See, e.g.*, Tr. 607.

Staff contended that if the Commission holds Nicor responsible for the actions of the Advisory Board, Nicor is more likely to exert greater influence than is contemplated by this structure. Staff recommended creating a board that is empowered to act in an advisory capacity only and to make it clear that Nicor is responsible for the decisions made. The advisory role of the board could provide useful input to Nicor regarding implementing programs while providing clear responsibility for those programs to Nicor. Staff Ex. 13.0 at 16; Staff Initial Brief at 164.

iii. The AG's Position

The AG contended that the Peoples Gas program structure followed by Nicor in this proposal, is designed to place the decisions regarding what programs would best serve Nicor's customers and achieve meaningful energy savings in the most cost-effective manner possible into the hands of a qualified, experienced and independent Advisory Board. Instead of being dependent upon Nicor, the AG averred, Nicor's proposed Advisory Board structure provides a mechanism for stakeholder input on nearly every aspect of the Energy Efficiency Plan. Nicor becomes one of several stakeholders, no more and no less authoritative than any other. The AG pointed out that the Commission will always retain the ultimate authority over the plan, not only with respect to approval of any extension of the plan beyond the proposed four-year pilot, but also with respect to the prudent expenditures of funds, periodic audits of plan performance, and any other reports the Commission might require. Should the Commission conclude that energy efficiency funds were imprudently spent by the Advisory Board, the AG opined that it could nevertheless order the refund of funds spent on those programs or terminate the program. AG Initial Brief at 74-75.

The AG further asserted that Nicor's proposed role as a fiscal agent would not make the Advisory Board "dependent" upon Nicor for its continued existence, as a fiscal agent retains only the checkbook; its authority is derived entirely from the management structure within which it is placed. It concluded that Nicor would have no authority to withhold any funds that the Advisory Board allocates to any approved program. The AG contended that Nicor's proposed program management structure places Nicor on an equal footing with the other members of the Advisory Board without interfering with the Commission's oversight authority. *Id.* at 75.

iv. The ELPC's Position

The ELPC argued that the Advisory Board structure proposed by Nicor will provide the best management and implementation of energy efficiency programs. It proffered that because Nicor has no experience in running energy efficiency programs, the program here can be run more effectively by hiring outside experts to administer the program. It also, according to the ELPC, gives external stakeholders meaningful participation in the design and implementation of the program.

The ELPC acknowledged that, pursuant to Nicor's proposed structure, the Commission would not be able to directly hold the Advisory Board financially responsible when a recovery of costs for the programs is disallowed. However, the ELPC continued, this is more than outweighed by the fact that the Advisory Board will not have to balance the needs of shareholders with those of customers. The ELPC averred that the likely members of the Advisory Board will be the Illinois Attorney General's Office, the Citizens Utility Board and the Environmental Law and Policy Center. These entities have no financial conflict of interest and their incentive is only to save their constituents money thorough energy efficiency programs. ELPC Initial Brief at 5-6.

v. Analysis and Conclusions

The problem with the structure of the Advisory Board that Nicor proposes is that this Commission has jurisdiction over Nicor but it may not have jurisdiction over other persons or entities that serve on Nicor's Advisory Board. Therefore, if Nicor's Advisory Board were to make an imprudent or a malfeasant expenditure under the current structure of the Advisory Board, ratepayers may have no recourse to recover that imprudent or malfeasant expenditure. We note that Nicor has asked for $13 million to fund this program, which is not a small amount of money. And, while initially, the Advisory Board will probably have members such as the Citizens Utility Board and the Attorney General's Office, there is no guarantee that in the future its members will be such public-service oriented entities.

On the other hand, Nicor has articulated a legitimate concern in that essentially the creation of an Advisory Board such as that which exists in the Commonwealth Edison and the Ameren Utilities' electric energy efficiency dockets, which are ones whereby the utilities have the financial control and the advisory boards merely advise, will delay implementation of Nicor's program until the winter heating season of 2010. Such a delay compromises the efficacy of Nicor's program.

However, we would be remiss in our duty to protect ratepayers from imprudence and malfeasance if we allowed Nicor to take $13 million from those ratepayers without any way to recover those funds, if they were to be imprudently spent. We conclude that some sort of compromise between the two positions and that of Nicor is in order.

Logically, in the beginning the Advisory Board will be determining what programs best suit ratepayers in Nicor's service territory. It will also commence the process of setting up those programs. Thus, the funds spent during this period of time would largely be on setting up energy efficiency programs. Therefore, in the beginning of the program there is less risk of imprudent or malfeasant expenditures. We also note that Nicor's plan is structured so that it may carry over 75% of the funds from the first year to the second year of the Plan. This is some indicia that Nicor anticipates that it may not actually be spending all of the funds during its first year. Allowing Nicor's proposed structure, at the beginning, permits Nicor to get its programs "up and running" with less chance of a compromise to the ratepayers' right to refunds of imprudently spent funds.

However, after the first fiscal year (December 31, 2009) Nicor shall reconfigure its Advisory Board in such a manner so that it shall have total financial responsibility for any expenditure made pursuant to its Energy Efficiency Plan. On January 1, 2010, Nicor's Advisory Board shall do what its name implies; it shall act solely in an advisory capacity. We further urge, but do not require, Nicor to consult with the existing Advisory Boards of the Ameren Utilities and Commonwealth Edison regarding the re-configuration of its Advisory Board. This compromise allows Nicor to commence the process of setting up its programs immediately, while, at the same time, ensuring that after January 1, 2010, ratepayers will have some recourse if energy efficiency funds assessed pursuant to Rider EEP are imprudently spent.

In making this conclusion, we are *not* concluding that it is likely that these funds will be imprudently spent. Rather, we are acknowledging that ratepayers have rights, including the right to a refund of imprudently spent funds. One of our duties is to ensure that this right is adequately preserved.

5. Rider 30 – Qualifying Infrastructure Plant ("QIP")

Nicor seeks to impose a cost pursuant to this Rider that would pay for its Program, which accelerates the replacement of its cast iron mains and copper services. The maximum annual amount that Nicor could impose pursuant to this Rider is $20 million. Staff and the AG opined that this Commission should reject Rider QIP because Nicor failed to demonstrate the need for this Rider. They further asserted that Nicor did not establish that this proposal would confer any benefits that would accrue to ratepayers as a result of imposing it.

Nicor agreed to the following tariff revisions suggested by Staff, if Rider QIP is approved: (1) an annual docketed reconciliation proceeding that would include a Factor O in the tariff formula for Commission-ordered adjustments; (2) a prudency and reasonableness of costs determination in this Commission reconciliation proceeding; (3) an annual internal audit with specific tests; and (4) a provision to exclude uncollectible expenses from the calculation of the Gross Revenue Conversion Factor. Nicor Ex. 29.0 at 58.

a. Staff's Position

In Staff's opinion, Nicor did not present evidence establishing that the performance of its cast iron main and copper services justifies an accelerated replacement program. Staff witness Mr. Anderson testified that from an engineering perspective Nicor's decision to accelerate the replacement of cast iron main and copper services should be based on the condition of the facilities to be replaced and the need for Nicor to continue to operate a safe and reliable natural gas system. Staff Exs. 9.0 at 6; 22.0 at 5-6.

Staff acknowledged that Nicor's rationale for accelerating its cast iron main and copper service replacement involves claims of safety, reliability, efficiency, customer satisfaction, reduced operation and maintenance costs, balanced work load, and a lower overall capital cost to complete the total replacement. However, according to Staff, Nicor is merely stating the obvious; if cast iron main and copper services are not replaced before their performance declines, then Nicor's system could experience problems with the safety, reliability, and efficiency of its system. Staff noted that in the past, Nicor has maintained a safe and reliable system with its historic replacement schedule. Staff concluded that Nicor did not demonstrate that its cast iron main and copper services are performing in a manner that is declining faster than what it experiences with its historic rate of replacement. Staff Ex. 9.0 at 4-8.

Staff noted that Nicor witness Mr. McCain testified that while the benefits that ratepayers receive from this program can not be quantified or identified, Nicor provided a figure of $6,000 in benefits per mile of replaced pipe. According to Staff, Mr. McCain's discussion shows the tenuous nature of expected ratepayer benefits under Nicor's replacement program. The most recent estimate of the cost of replacing mains is $416,761 per mile. Staff thus concluded that there is a considerable gap between the cost of this program and the benefits that have been identified for ratepayers pursuant to this program. Staff Ex. 20.0 at 9-10.

Staff pointed out that Nicor is not the only Illinois utility conducting a cast iron main replacement program. In fact, Peoples Gas has been conducting such a program since 1981. However, in the last Peoples Gas rate case, the Commission rejected Peoples Gas' proposed rider to cover its cast iron replacement program. At that time, the Commission expressed concern about the lack of evidence that Peoples Gas presented in support of its proposed Rider. The Commission concluded the following in that docket:

> [T]he Utilities' proposal is insufficient for the Commission to approve it. It might have been easier to approve the rider had the Utilities included, or the Staff or the Intervenors' elicited, such information as: a detailed description and cost analysis of the proposed system modernization; an identification and evaluation of the range of technology options considered and analysis and justification of the proposed technology approach; a detailed identification and description of the functionalities of the new system, related both to system operation as well as on the customer side of the meter, as well as an identification and justification of functionalities foregone; analysis of the benefits of the system modernization, both to system operation as well as to customers; these benefits should include reductions in system costs as well as an analysis of the range and benefits of potential new products and services for customers made possible by the system modernization; an analysis of regulatory mechanisms to allow companies to both recover their costs of system modernization as well as to flow reduced system costs back to customers; and an identification and analysis of legal or regulatory barriers to the implementation of system modernization proposals.

Peoples Gas Rate Case Order, Docket 07-0241.

Staff submitted that Nicor did not establish that its proposed infrastructure replacement program meets the evidentiary requisites articulated by the Commission above. According to Staff, Nicor did not meet its burden to establish that the acceleration of the replacement of cast iron mains and copper services would have any impact on its ability to provide safe and reliable service to its customers. Staff stated that Nicor has conducted no formal study to determine what the replacement rate should be. To Staff, this demonstrates that Nicor has not provided a quantification of the benefits of the program's effect on such items as safety, reliability, efficiency, customer satisfaction, reduced operation and maintenance costs, balanced workload, and lower overall capital costs. Staff Ex. 22.0 at 4-6.

Staff further contended that Nicor did not establish that the level of revenues to be collected under the proposed Rider would justify the time and expense required for Commission oversight of this Rider. Staff pointed out that this Commission would need to devote regulatory resources to overseeing and administering this Rider, in order to ensure that only reasonable costs are passed along to ratepayers. Staff concluded that Nicor could have accelerated its cast iron main and copper service replacement program before filing this rate case but, it chose not to do so.

Finally, Staff added that this Commission should proceed cautiously before committing financially stressed ratepayers to a rider that will increase their gas bills. Staff Ex. 7.0 at 21-22.

b. The AG's Position

i. The AG's Factual Arguments

The AG, like Staff, is of the opinion that Nicor's proposed Rider QIP is not needed, and therefore, it is not warranted. According to the AG, Rider QIP would recover the return on, (a full pre-tax return) and through, depreciation expense, of the incremental annual capital investment under an accelerated cast iron main and copper services replacement program. The annual expenditures to be recovered in the rider are tied to an incremental increase in the number of miles of cast iron main and copper services that are replaced.

The AG pointed out that Nicor does not earn a return on the capital it invests in replacing cast iron mains and copper services between rate cases. However, Nicor has opined that it has an economic disincentive under its current rate design to make accelerated yearly capital investments because its ability to earn a return on these additional investments will be delayed until the conclusion of a rate case. Rider QIP surcharges would provide Nicor with the opportunity to begin to recover the return on the increased amounts of its annual capital investment under an accelerated replacement program, when those investments are made, rather than delaying recovery to the next rate case. The AG averred that Nicor expects to realize a quantifiable annual reduction in O&M expense of approximately $3,200 per mile of cast iron main replaced. The AG proffered that pursuant to Rider QIP, Nicor would recover a pre-tax rate of return of 13.68% and depreciation expense of 4.1%. Thus, for each $1,000 in investment, Nicor would recover approximately $178 in revenue requirement from customers. AG Initial Brief at 77, 79-80.

The AG averred that Nicor justified its proposal to add $20 million annually through Rider QIP by arguing that it's inefficient and costly to maintain its old cast iron main and copper services. However, the AG maintained, Nicor's existing risk management and pipeline optimization program has sufficiently operated to ensure that the mains and copper services are replaced at a rate that ensures safety, reliability and cost-effectiveness. AG Initial Brief at 79-80.

The AG cited the testimony of Nicor witness Mr. McCain, who testified that Nicor's process for replacing cast iron mains cost-effectively balances the need to replace aging facilities. Nicor personnel develops a framework for scheduled replacements by tracking the actual performance of the assets over time, considering factors such as, a pipe's condition, its leak history, its cathodic protection history, municipal street resurfacing plans and expected maintenance costs. The areas of Nicor's service territory that show decreased performance are then prioritized for cast iron pipe replacement. Of Nicor's 34,002 miles of main, only 398 are cast iron. The AG asserted that, irrespective of whether the Commission approves Rider QIP, Nicor will continue to employ this risk-based approach to main replacement.

Also, Nicor's existing mechanisms for evaluating and replacing mains and services have been successful. AG witness Mr. Rubin's analysis of Nicor's risk management and pipeline optimization program supports that conclusion. He reviewed the U.S. Department of Transportation's (the "USDOT") Office of Pipeline Safety data base, which shows the inventory of mains (in miles) and services (by number) by type of material. He compared Nicor's leak rates to those of a peer group of natural gas delivery companies. This comparison showed that Nicor experiences a lower leak rate from its mains than its peers' experience, specifically, 5.3 leaks per 100 miles for Nicor, compared to 9.8 leaks per 100 miles for its peers. With regard to copper services, however, Nicor experiences a higher leak rate of 7.0 leaks per 100 services compared to 3.7 leaks per 100 services for its peer group. He surmised from his analysis that Nicor does not appear to be significantly different from the peer group. He concluded that it appears that Nicor is in a very similar position to its peers in the industry. AG/CUB Ex. 2.0 at 9.

Mr. Rubin additionally evaluated information to determine if Nicor's system appears to be deteriorating at an unusual rate. He concluded that Nicor has substantially reduced the number of leaks overall on its cast iron mains since 2003. The information that Nicor provided to Mr. Rubin established that the number of leaks on Nicor's cast iron mains have declined by 75% since 2003. Since 2003, Nicor's optimization and prioritization program has worked, as it has resulted in a substantial reduction in the leak rate on its cast iron system. According to Mr. Rubin, this program has achieved a level of performance that would have been expected from the non-optimized replacement of nearly five times as much main as Nicor actually replaced. AG/CUB Exs. 2.0 at 38; 2.11 at 5.

The AG maintained that Nicor did not perform an analysis showing that it would be cost-effective to replace mains and services more rapidly than its current optimization program would indicate is reasonable. The estimated $356,000 cost to replace one mile of cast iron main would result in a revenue requirement of approximately $63,300 in the first year, declining by approximately $2,000 per year, due to accrued depreciation. However, Nicor's estimated annual savings from replacing a mile of main is only $3,242 per year; thus, the annual revenue requirement in the first year would be approximately 20 times greater than the annual savings that would be expected from such an investment. Even after a new mile of main was depreciated for 20 years, the annual revenue requirement still would be at least seven times higher than the expected savings in operating and maintenance expenses. The AG concluded that just the annual depreciation expense of more than $14,000, with no return on the investment at all, exceeds the expected annual operating savings by more than 400%. AG/CUB Ex. 2.0. at 41.

ii. The AG's Legal Arguments

Similar to the arguments the AG made opposing adoption of Rider VBA, the AG argued that Rider QIP is illegal. Pursuant to *A. Finkl & Sons,* 250 Ill. App. 3d at 317, the AG averred that rider recovery constitutes extraordinary regulatory treatment that should be used only when compelling evidence exists establishing that traditional ratemaking will not effectively reflect the costs in rates. Therefore, to qualify for rider recovery, the expenses that a utility seeks to recover with a rider should be unexpected, volatile or fluctuating and significant in nature. The AG averred that here, however, Rider QIP fails to satisfy these criteria. The AG concluded that there is nothing "unexpected" or "volatile" about Nicor's existing or accelerated main replacement and infrastructure investment program. Also, because Nicor failed to satisfy its burden of proving that an accelerated infrastructure replacement program is necessary to provide safe, reliable, least-cost service, Nicor cannot legitimately claim that the investment dollar level is so significant that rider treatment is justified. AG Initial Brief at 90.

The AG also argued that Nicor's proposed Rider QIP violates the Public Utilities Act's prohibition against single-issue ratemaking. Instead of considering costs and earnings in the aggregate, where potential changes in one or more items of expense or revenue may be offset by increases or decreases in other such items, Nicor's Rider QIP considers changes in infrastructure investment in isolation, ignoring the totality of ratemaking circumstances, thereby constituting illegal single-issue ratemaking. Further, the AG contended, Rider QIP violates the Public Utilities Act's prohibition against retroactive ratemaking, citing 220 ILCS 5/9-201, because Rider QIP would generate monthly surcharges determined by computing the difference between the average baseline level of capital additions and Nicor's actual capital expenditures, thus triggering rate changes after the time when overall rates are set in this docket. *Id.* at 91-92.

The AG additionally averred that QIP recovers additional revenues for capital expenditures, beyond those approved in this rate case, in violation of the Commission's test-year rule. It argued that the calculation of Nicor's plant additions or capital expenditures, for purposes of setting rates, is subject to test-year principles. However, the AG continued, Rider QIP would provide expedited, piecemeal, rate increases for incremental capital investment between rate case test years, in violation of the Commission's test year rules. Also, according to the AG, Rider QIP violates the ratemaking rule which requires that only the utility plant that is found to be used and useful and prudently incurred can be incorporated into rates. This is true because Rider

QIP permits monthly surcharges on customer bills to cover the return on, the accelerated investment in the replacement of cast iron mains and copper services. Piecemeal rate increases, the AG concluded, would occur on a monthly basis without any Commission review of the prudency of the Rider QIP investments. Finally, the AG averred that Rider QIP violates the requirement in the Public Utilities Act that rates must be least-cost. *Id.* at 93-95, citing 220 ILCS 5/1-102, 1-102(a), 8-401.

c. Nicor's Position

Nicor asserted that Rider QIP would allow it to recover certain additional capital investments in a timely fashion to facilitate the ongoing replacement of its cast iron mains and copper services. According to Nicor, this Rider is based upon the Commission's guidelines that were set forth in the 2007 Peoples Gas Rate Case. Rider QIP is a mechanism, through which Nicor would accelerate infrastructure replacement by permitting it to recover a return on, and depreciation expense related to, its investment in certain qualifying future incremental cast iron main and copper services replacement. Nicor Initial Brief at 120.

Nicor further asserted that to be eligible for this program the plant additions must meet the following criteria: a.) they must replace cast iron main or copper service lines; b.) they must be installed after the conclusion of the test year in Nicor's most recent rate case; c.) they must not have been included in the calculation of rate base in Nicor's most recent rate case; d.) the plant additions will be included in 83 Ill. Adm. Code Part 505, Accounts 376, Distribution Mains, and 380, Services; e.) only cast iron main replacements that are above and beyond the first 15 miles of main replacement may be classified as QIP in any calendar year; f.) only incremental copper service replacements that are above and beyond the first 3,500 service replacements may be classified as QIP in any calendar year; and g.) the maximum amount of investment that can be classified as QIP in any calendar year is $20 million. *Id.* at 121.

A single QIP percentage would be determined each year, based upon the proportion of the prior year's QIP, less accumulated depreciation, times a pre-tax return, plus depreciation, less operational savings, divided by the forecasted QIP base rate revenues during April through December of the effective period. Applicable monthly base rate revenues would be multiplied by the QIP percentage. That amount would be added as a separate line item on customer bills. A reconciliation of the previous year's actual billed QIP charges with the costs that were intended to be recovered during the effective period would be conducted. Any reconciliation adjustments, including carrying costs at the rate established by the Commission under 83 Ill. Adm. Code § 297.70(e)(1), would be included in the QIP percentage.

Nicor averred that it has provided ample reason to accelerate the replacement program. It identified cast iron main and copper services as the greatest threat to its system. The leak rate per mile for cast iron main is 11.21 times higher, or 1020% higher, than the leak rate for other materials in Nicor's system. The leak rate for copper services is 4.77 times higher, or, 377% higher, than the leak rate for the rest of the services in the system. Rider QIP allows Nicor to replace these materials within 10 years. If this Commission were to deny Nicor's request for Rider QIP, Nicor projects that it will take 32 years to replace the copper service and cast iron mains. Nicor Ex. 39.0 at 3-4.

According to Nicor, Rider QIP will allow it to make replacements at a rate that would better keep pace with, or even move ahead of, the declining performance of the materials to be replaced. Planned accelerated replacement of these materials allows for a more balanced workload, as opposed to experiencing the spikes in workload that occur when there is material failure. This results in improved reliability, and reduced material and labor costs for meter readings, maintenance, and surveying. Nicor Ex. 5.0 at 9-11.

Nicor acknowledged that it is difficult to directly link any cost savings from Rider QIP to the replacement of materials that are integrated into the current system. Nicor also acknowledged that the intangible benefits of material replacement are also difficult to precisely quantify. It maintained, however, that Rider QIP provides benefits to ratepayers in the amount of $6,000 per mile of replacement. The remaining benefits will inure to Nicor's ratepayers when Nicor's operating cost savings are reflected in future rate case proceedings. Further, Nicor asserted, Rider QIP will increase efficiency by eliminating the need for training and hiring employees to address a specialized area, as, only 1.34% of Nicor's entire distribution system is cast iron main. Other benefits are: more efficient leak investigations as lower-pressure segments of the system are eliminated, as well as the elimination of the need to get inside customer's premises as meters are relocated when cast iron mains are replaced. Nicor Ex. 20.0 at 4-5.

d. Analysis and Conclusions

This Commission made it abundantly clear, in the Peoples Gas Rate Case, what a utility must present in order to establish a need for a Rider recovering main replacement costs is:

> [A] detailed description and cost analysis of the proposed system modernization; an identification and evaluation of the range of technology options considered and analysis and justification of the proposed technology approach; a detailed identification and description of the functionalities of the new system, related both to system operation as well as on the customer side of the meter, as well as an identification and justification of functionalities foregone; analysis of the benefits of the system modernization, both to system operation as well as to customers; these benefits should include reductions in system costs as well as an analysis of the range and benefits of potential new products and services for customers made possible by the system modernization; an analysis of regulatory mechanisms to allow companies to both recover their costs of system modernization as well as to flow reduced system costs back to customers; and an identification and analysis of legal or regulatory barriers to the implementation of system modernization proposals.

Peoples Gas Rate Case Order, Docket 07-0241, at 162. As Mr. Anderson and Mr. Rubin have noted, however, the type of evidence presented falls far short of these requirements.

In fact, other than stating facts establishing that it will have a generally improved system through cast iron main and copper service replacement at a faster pace, Nicor provides no evidence in support of its claim that these mains and copper services need to be replaced, within the next 10 years, as opposed to 32 years. We note that the difference between what ratepayers are paying now for this maintenance would increase ratepayers' bills during the next 10 years. And, as both Mr. Anderson and Mr. Rubin concluded, Nicor's current system, through which it replaces these items when such replacement is needed, works very well. Nicor currently replaces its cast iron mains and copper services, and it will continue to replace them, irrespective of anything this Commission orders here. While Nicor established that the cast iron mains and copper services are old, even outdated, and more leaky than other portions of its distribution system, there is no evidence that Nicor's current method of replacing cast iron mains and copper services is inadequate, unsafe or insufficient. In fact, Mr. Rubin concluded that the number of leaks in Nicor's cast iron mains has decreased by 75% since 2003.

In summary, what Nicor has proven, at best, is only that Rider QIP would allow Nicor to better keep pace with the declining performance of the materials in question. It has provided us with no reason to impose the additional cost of "better keeping pace" upon ratepayers, many of whom are, as Nicor has acknowledged, facing difficult financial times. Nicor's evidence does not establish that it meets the requirements set forth above, which were articulated in the Peoples Gas Rate Case Order. In the future, we encourage parties to adhere to the evidentiary requisites set forth in one of our orders, when, as is the case here, that order is directly on point as to what proof is needed to establish a particular argument.

Nicor's request to impose Rider QIP, therefore, is denied. We conclude that Nicor did not meet its burden of proof to provide facts establishing the need for this Rider, we need not address the AG's legal arguments that Rider QIP should not be implemented.

XIII. TERMS AND CONDITIONS

A. UNCONTESTED ISSUES

(1) Nicor proposed to increase the charge for damaging its non-steel service pipes, sized 1-1/8 inch or less, from $260.00 to $410.00. Nicor did not object to Staff's proposed reduction of the charge from $410.00 to $408.50. Based upon the evidence in the record, the Commission concludes that the updated charge for damaged non-steel service pipes, sized 1-1/8 or less, is just and reasonable.

(2) Nicor increased the per-foot charge for installation of gas service pipe for residential and small commercial customers (Meter Class A) that exceeds the first 60 feet. Staff recommended approval, and no other party raised an objection. Based upon the evidence in the record, the Commission

concludes that the updated per-foot charge for installation of gas service pipe is just and reasonable.

(3) Nicor proposed to increase the charge for service reconnection after a discontinuation for non-payment of service from $23.00 to $42.00. Staff recommended approval; no other parties raised an objection. Based upon the evidence in the record, the Commission concludes that the updated charge for service reconnection is just and reasonable.

(4) Nicor proposed to eliminate references to the “bimonthly” billing program in its tariff sheets. Staff recommended approval, and no other party raised an objection. Based upon the evidence in the record, the Commission concludes that the elimination of the bimonthly billing program is just and reasonable.

(5) Nicor proposed to eliminate item (g) on Sheet No. 42, which applies to buildings of at least four stories and provides that (1) underground service pipe will be installed at no charge, and (2) Nicor own, operate and maintain vertical gas risers within the building. The program is being eliminated due to limited use over the past ten years. Staff recommended approval, and no other party raised an objection. Based upon the evidence in the record, the Commission concludes that the elimination of the vertical gas riser program is just and reasonable.

(6) Nicor proposed to update Sheet No. 54 – Bill Format to include the proposed charges for Rate 1 (Residential Service). No party objected to Nicor’s proposal. Based upon the evidence in the record, the Commission concludes that the bill format update is just and reasonable.

(7) Nicor proposed to make a variety of “housekeeping” changes on Sheet Nos. 33, 34, 35.5, 38, 46, 50, 50.1 and 52.5 to further clarify or remove outdated language. Staff recommended approval. No party objected to changes. Based upon the evidence in the record, the Commission concludes that the changes are just and reasonable.

(8) Nicor proposed to update the Table of Contents (Sheet No. 1.5) to incorporate its proposed changes in this proceeding. No party opposed this update. Based upon the evidence in the record, the Commission concludes that the update to the Table of Contents is just and reasonable.

(9) Nicor proposed to update the list of municipalities and unincorporated contiguous territories to which the schedule of rates applies on Sheet Nos. 2 through 9. Staff recommended approval, and no party raised an objection. Based upon the evidence in the record, the Commission concludes that the updates to Sheet Nos. 2 through 9 are just and reasonable.

(10) Nicor proposed to standardize the language within its non-residential tariffs to indicate that the initial term shall commence when Nicor begins to

supply service, to clarify its telephone line requirements for daily metered Rates 6 and 7, and to make other miscellaneous "housekeeping" item updates on Sheet Nos. 11, 11.5, 12, 14, 21, 24 and 28. Staff recommended approval. No party raised an objection. Based upon the evidence in the record, the Commission concludes that the clarification to Rates 6 and 7, and updates to Sheet Nos. 11, 11.5, 12, 14, 21, 24 and 28 are just and reasonable.

(11) Staff recommended making a change to Nicor's third revised Sheet No. 7, which identifies the Village of Niota as being in Cook County rather than Hancock County. Nicor accepted Staff's change. Based upon the evidence in the record, the Commission concludes that the update to Sheet No. 7 is just and reasonable.

(12) Staff recommended, for the purposes of the MDN determination, that "the Company shall accept anticipated monthly usage provided it is substantiated by the Customer." Nicor accepted Staff's recommendation. Based upon the evidence in the record, the Commission concludes Staff's recommendation is just and reasonable.

(13) Nicor proposed to make a variety of "housekeeping" changes on Sheet No. 12, particularly to the Gas Supply Cost Paragraph, where Nicor proposed to change the Gas Supply Cost charge from (1) 0.53 to 0.50 times the Customer's Maximum Daily Contract Quantity multiplied by the Demand Gas Costs; and (2) the Commodity Gas Cost multiplied by the Customer's usage supplied by Nicor in the billing period. Staff recommended approval and no party objected to these changes. Based upon the evidence in the record, the change is just and reasonable.

B. CONTESTED ISSUES

1. Non Sufficient Funds ("NSF") Charge

a. Nicor's Position

Nicor proposed to increase the charge for returned checks for non-sufficient funds ("NSF") from $16.00 to $25.00. It argued the NSF charge would act as a reasonable deterrent to customers who utilized invalid checks. Additionally, it alleged that the proposed $25.00 NSF charge would bring its fees in line with the prevailing fees charged by other gas utilities in Illinois as approved in prior dockets. Nicor cited Commission decisions in the 2007 Peoples Gas Rate Case and the MidAmerican Energy Company Rate Case to support its argument. Staff raised no objection to the approval of the Company's proposed NSF charge. *See,* 2007 Peoples Gas Rate Case Order at 261, MidAmerican Energy Company, Docket 88-0534, Order at 40.

Nicor argued that the Commission has determined on more than one occasion that a utility's NSF fee need not be based solely on the utility's cost. The Company pointed to the Commission's decisions in the Peoples Gas and Mid American cases as examples where the Commission found the higher NSF fees were reasonable and a deterrent to customers who tendered bad checks. It maintained that the opposition to the NSF fee proposed by the AG and CUB should be rejected by the Commission based on the 2007 Peoples Gas Rate Case which concluded: "[T]he Commission is not made aware of any good reason to abandon, in this instance, the logic that drove our result in the *MidAmerican Energy* case." It argued that CUB's position that a NSF fee will result in double recovery is incorrect. Rather, the Company argued, the revenues generated from the NSF charge actually served to reduce the rates of customers who make valid payments, thereby eliminating any concern regarding double recovery.

Nicor also noted that the Commission has previously recognized that in instances where it was reasonable to do so, it would consider its past practice in resolving an issue. It concluded that since the Commission's past practice permitted NSF fees that contained a deterrent factor, it is reasonable to continue this practice. Nicor also concluded that neither the AG nor CUB provides an adequate rationale for the Commission to abandon its past practice of NSF fees. Nicor Initial Brief at 127-128.

b. AG/CUB Position

AG/CUB asserted that the charge for a returned check payment should actually be set to recover the costs incurred by the utility. AG/CUB contended that the proposed increase to the NSF fees should be rejected, because Nicor has not demonstrated that this increase is cost-based. AG/CUB Ex. 2.0 at 38.

AG/CUB argued that the evidence presented showed that Nicor does not incur costs in the amount of $25.00 when a customer payment is returned from the bank. In fact, Mr. Rubin testified that the Company's cost to process a returned payment, excluding carrying charges, is actually only $15.04. Nicor itself only claimed that its total cost to process a return check payment is $17.59. Though the evidence demonstrates this figure is inflated, the AG/CUB averred, it does not even approach the $25.00 Nicor seeks to charge customers. *Id.* at 41.

AG/CUB pointed out that the $17.59 cost claimed by Nicor includes labor costs of $12.52, a bank charge of $1.75 for processing a returned payment, and a carrying cost of $3.33. Mr. Rubin testified that, despite Nicor's arguments to the contrary, it is inappropriate for Nicor to collect carrying costs on this expense, considering that Nicor's cash working capital request included a calculation of the average revenue lag. As Mr. Rubin testified, "attempting to recover costs associated with a portion of the revenue lag again through the bad check charge is inappropriate and would result in a double recovery of a portion of the Company's working capital needs." Excluding carrying charges, Nicor's total costs are $14.27. AG/CUB stated that even if a working capital allowance is added, which Mr. Rubin testified should be no more than $0.78, the total cost of this service is $15.04. Thus, Mr. Rubin recommended that the current $16 bad check (NSF) charge should remain unaltered and that Nicor's proposed increase should be rejected. *Id.* at 41.

AG/CUB asserted that because Nicor could not support its increase request with evidence of its costs matching its requested charge, it instead provided two policy justifications: (1) to bring its bad check charge in line with other utilities in the state; and (2) to create an incentive for customers to make proper remittances to the Company. AG/CUB alleged that neither one of these rationales are sufficient to justify the substantially higher requested bad check charge. The fact that other utilities in the state have different bad check charges does not have any effect on the determinations the Commission must make in this proceeding regarding Nicor's costs, as, evidence of other utilities' costs is not in this record. Also, while some utilities have a higher bad check charge, others are lower than Nicor's current charge. AG/CUB pointed to general ratemaking principles and the Public Utilities Act, which states: "all rates or other charges made, demanded or received by any product or commodity furnished or to be furnished or for any service rendered or to be rendered shall be just and reasonable." *Id.* at 14; *see also* 220 ILCS 5/9-208.

AG/CUB further argued that when a customer sends a payment that is returned for insufficient funds, that customer is already charged a fee by its bank and also by Nicor. Mr. Rubin testified that this is enough of an incentive to discourage bad checks, because a $25.00 charge would not have a much greater deterrent effect than the current $16.00 charge. AG/CUB concluded that Nicor provides no evidence that charging a higher rate would affect customer behavior. AG/CUB Ex. 5.0 at 4.

c. Analysis and Conclusions

Nicor proposes to increase its charge for a check returned for non-sufficient funds from $16.00 to $25.00. As a basis for its argument, it states that the increased NSF charge would serve as a deterrent to customers who tender bad checks. It also argues the proposed increase would bring its NSF charges in line with the prevailing fees charged by other gas utilities in Illinois as approved by the Commission. Nicor argues that the NSF fees charged by utilities should not be based solely on the utility's costs. To support its argument for higher fees, Nicor refers to the 2007 Peoples Rate Case and 1999 MidAmerican Rate Case as examples where the Commission recognized the NSF fee could be construed to be a deterrent to customers who pass invalid checks. The Nicor's position on this issue was uncontested by Staff. The AG and CUB both oppose any increase in the NSF charge and argue that Nicor has not provided sufficient evidence to establish a reasonable and prudent basis for increasing the fees in this proceeding.

The AG and CUB also challenge Nicor's argument that increasing the NSF fee would act as a deterrent to customer NSF checks. They contend that Nicor's position is based on a false assumption that customers intentionally tender bad checks. They believe it is unlikely that an increased fee of $25.00 would serve as any stronger a deterrent than the current $16.00 fee or that the average customer would need an additional restriction other than the individual bank fees charged for NSF items.

In our analysis, Nicor has not provided a reasonable basis for the Commission to grant an increase in the NSF fee to $25.00. As with all other customer-related expenses, the NSF fee should be tied to a reasonable and measurable cost. While Nicor did present calculations which showed its NSF costs are $17.59, it has failed to provide sufficient information to reasonably support increasing the fee to $25.00. The

Commission does not agree that Nicor should benefit from an increase in the NSF fee revenue without providing proof of an increase in costs associated with receiving bad checks. The Commission does not believe the increase in costs would create any greater a deterrent to a customer than the current fee, especially since a customer will incur a returned check fee from his own lending institution. We also agree with Mr. Rubin that the total cost for an NSF check is $15.04, not $17.49. As such, the Commission does not approve the Nicor's proposal to increase its NSF fees to $25.00.

XIV. REVENUES

A. TOTAL BILLING UNITS/ RATE 4 AND RATE 74 BILLING UNITS

AG/CUB propose to increase the forecasted total billing units for the 2009 test year by proposing increases in Rate 4 and Rate 74 billing units. AG/CUB's proposal would reduce the Company's annual revenue requirement by $1,441,000.

1. The AG/CUB Position

AG/CUB witness Effron argued that Nicor has under-forecasted its 2009 Rate 4 and Rate 74 billing units. Mr. Effron proposed to increase the billing units for those two rate classes, and a corresponding increase to Nicor's total forecasted 2009 billing units so that its test year base rate revenues under present rates will be increased by $1,441,000. AG/CUB Ex. 1.0 at 16-18, Ex. 4.0 at 7-9.

Mr. Effron testified that data supplied by the Company does not support the decreases being projected in Rate Classes 4, General Service, and 74, Transportation Service. AG/CUB Ex. 1.0. He recommended that the actual therm sales per customer in 2007 for those rate classes should be used for the purpose of forecasting test year sales, including adjusting for customer migration between classes.

AG/CUB argued that, although Nicor forecasts a decrease in use per customer in Rate Classes 4 and 74, data provided by the Company shows conflicting trends in actual therm sales per customer in these two rate classes. Nicor Schedule C-1. For Rate Class 4, Nicor forecasts a decrease in use per customer by 1.4% in 2008 and 0.2% in 2009. AG/CUB maintained that this is apparently based on the actual experience in the years 2005 – 2007. AG/CUB countered that the data provided by Nicor shows a decrease in use per customer of 3.1% in 2006, followed by an increase in use per customer of 2.5% in 2007. For Rate Class 74, Nicor forecasts a decrease in use of 2.9% in 2008 and no significant change in 2009. AG/CUB stated that this again is apparently based on the actual experience in the years 2005 – 2007. Nicor additionally provided data which shows an increase in use per customer by 1.1% in 2006, followed by a decrease in use per customer of 1.2% in 2007. AG Initial Brief at 97-98.

AG/CUB argued that the Company has not provided data that would establish that the use per customer for Rate Classes 4 and 74 can be expected to decrease to any significant extent in 2008 and 2009. AG/CUB stated that even if data incorporating migration of customers from Rate Classes 4 and 74 to Rate Classes 5 and 75 is included, Nicor's projection is based upon conflicting data. Nicor provided the use per customer for

Rate Classes 4 and 5 on a consolidated basis. Also, Nicor's data for Rate Classes 74 and 75 was on a consolidated basis. AG/CUB conclude that an adjustment should be made to increase test year revenue base rate revenues by $1,441,000 to reflect the use per customer of those rate classes on a consolidated basis. AG Initial Brief at 98.

2. Nicor's Position

Nicor witness Pepping stated that the AG/CUB proposal improperly inflated 2009 forecasted billing units. Ms. Pepping argued that this proposal artificially inflates the amount of gas forecast to be sold in the test year, which results in an improper reduction of $1,441,000 to the Company's revenue requirement. Ms. Pepping explained that the Company's forecasting methodology for total billing units over a 10 year period has been within an average of 1.5% of actual usage, and that the Commission should use its forecast of total billing units. Nicor argued that Staff takes no issue with the Company's forecasted total billing units for the 2009 test year. Staff also does not object to its proposed allocation of that total among its various customer classes. Nicor Ex. 50.0 at 3-5; Nicor Initial Brief at 129.

Ms. Pepping testified that billing units represent the therms of gas the Company delivers to its customers under normal weather conditions and that billing units are used to calculate charges to individual customer classes to ultimately determine how the Company will recover its Commission-approved revenue requirement from its customers. Ms. Pepping stated that Nicor forecasts the total annual usage, or billing units, for rate case purposes as well as for financial and other reasons. For a rate case, it first determines its total billing units for the test year, and then allocates that total among its various customer classes, based upon an analysis of each class' historic usage pattern. Nicor Ex. 50.0 at 3-4; Nicor Initial Brief at 128.

Ms. Pepping testified as to three reasons why Mr. Effron's contention is improper. First, Mr. Effron's approach ignores the fact that the Company has historically been very accurate in forecasting total billing units. Despite this, Mr. Effron would like to make an upward adjustment in billing units to two rate classes and then increase total billing units by the sum of the increase for the two rate classes. Nicor Ex. 50.0 at 3-4; Nicor Initial Brief at 129-30.

Mr. Effron's approach also failed to examine the historic trend in usage patterns. Ms. Pepping stated that Mr. Effron's proposed adjustments to Rate 4 and Rate 74 billing units are based on two years of data. Ms. Pepping explained that when allocating total annual billing units among customer classes, it is far more accurate to analyze the historical patterns of usage, or trends. Ms. Pepping noted that Nicor used three and five year periods to examine historical usage. When examined the trend in usage for Rate Classes 4 and 74, it is evident that these classes have demonstrated a declining pattern of usage per customer. Ms. Pepping submitted that Nicor's forecasted usage for Rate Classes 4 and 74 is consistent with this trend. Lastly, Ms. Pepping argued that Mr. Effron's proposal to adjust total billing units conflicts with Nicor's evidence of the decline in usage per customer, as well as testimony from Staff witness Brightwell, ELPC witness Kubert and AG/CUB witness Rubin who all recognize this ongoing declining usage trend. Nicor Ex. 50.0 at 5-7.

3. Analysis and Conclusions

The Commission finds that Nicor has demonstrated that its forecasted test year total billing units, and its allocation of such billing units among customer classes, is reasonable and should be used for setting rates. AG/CUB's proposed adjustment to increase Rate 4 and Rate 74 test year billing units inflates total test year billing units. The evidence and testimony in this proceeding demonstrates that per-customer usage has been decreasing particularly when analyzed over three- and five-year periods. AG/CUB's claim looks at a two-year pattern of usage for these two customer classes. Nicor presented evidence demonstrating that its average forecast to normalized actual variance was just 1.5% over a 10-year period. Testimony from Staff witness Brightwell, ELPC witness Kubert and AG/CUB witness Rubin recognize that Nicor has experienced a declining usage trend. AG/CUB's assertion that the Commission adopted a similar adjustment in Nicor's 2004 Rate Case counters the evidence here which demonstrates that AG/CUB's approach is less accurate. We note that Nicor points to evidence showing that Mr. Effron's approach over-stated total billing units by 4.5%, which resulted in the Company suffering an annual revenue loss of $5.4 million since the conclusion of the 2004 Rate Case. The Commission finds that AG/CUB's proposal to increase the forecasted total billing units for the 2009 test year by proposing increases in Rate 4 and Rate 74 billing units should be rejected.

B. NICOR ENERGY SERVICES BILLING ADJUSTMENT

Staff seeks to impute a $0.25 per bill charge for billing services that Nicor provides to Nicor Energy Services, instead of the $0.112 per bill currently being charged. Staff's proposal would reduce the Company's annual revenue requirement by $588,000. AG/CUB support Staff's recommendation.

1. Staff's Position

Staff witness Hathhorn proposed to impute the $0.25 per bill charge because she maintained that the billing services being charged to Nicor Energy Services are the same billing services as that which was provided to Nicor Solutions. Ms. Hathhorn asserted that the Nicor's billings to Nicor Energy Services should be charged at the prevailing rate, rather than at Nicor's fully distributed costs, since it performs essentially the same services to Nicor Solutions and charges Nicor Solutions a prevailing rate. The Operating Agreement requires the affiliate to charge a prevailing rate if that rate is higher than fully distributed costs. Staff Ex. 15.0 at 12-14, Sched. 15.05.

In Staff's opinion, the only difference proffered by the Company is how it provides billing services to both Nicor Solutions and Nicor Energy Services is that Nicor Solutions uses a different billing system than Nicor Energy Services. Staff argued that use of a different billing system is not sufficient to justify why the Company charges Nicor Energy Services only fully distributed costs, rather than a prevailing price, for what appears to be the same billing services to Nicor Energy Services.

Nicor argued that charging Nicor Energy Services fully distributed costs is consistent with its Commission-approved Operating Agreement. Staff counters that the Commission has held that it is not bound to approve charges in rates simply because they were recorded according to a Commission-approved affiliate interest transaction agreement. Staff Initial Brief at 175.

Staff also mentioned concerns regarding the Company's affiliate transactions and recommended an investigation into the current Operating Agreement. Staff maintained that it would be inappropriate for its adjustment to be denied solely upon reliance that it was accounted for under a Commission-approved agreement.

In response to Nicor's attempt to distinguish the services provided by the two affiliates, Staff argued that Nicor Solutions and Nicor Energy Services provide different services to customers, but both companies receive their billing services from Nicor. Staff maintained the billing of services to an affiliate is essentially the same. Staff concluded that Nicor has not demonstrated why it is reasonable to bill its affiliates at two different rates for such similar services. Staff Initial Brief at 176-77.

2. Nicor's Position

Nicor stated that it provides one billing service to Nicor Services and an entirely different billing service to Nicor Solutions, and does so under completely separate fee structures. The Company asserted that it developed a billing service used solely by Nicor Energy Services that assesses a straightforward recurring monthly fee. It argued that the billing service offered to Nicor Energy Services was programmed to address only the specific needs of Nicor Energy Services. The Company points to the testimony of Staff witness Hathhorn, who agreed that no other party uses the service that is being provided to Nicor Energy Services. Tr. 468-469. Regarding the fee structure, it stated that Nicor Energy Services: (1) paid an initial fee to develop this unique billing system; (2) pays ongoing system maintenance fees, when appropriate; and (3) pays a $0.112 per bill charge, which is assessed pursuant to Nicor's Commission-approved operating agreement.

Nicor cited to evidence showing that Nicor Solutions uses a completely different billing program. This other billing program is also used by various alternative retail gas suppliers under Nicor Gas' Customer Select program ("Customer Select suppliers"). Staff witness Ms. Hathhorn agreed that Nicor Solutions and Customer Select suppliers utilize the same billing system. Tr. 469. Nicor noted that this billing program is more complex than the one Nicor Energy Services uses, requiring the assembly of individual customer consumption data to compute monthly bills. It maintained that Nicor Solutions is billed at the same tariffed rate as Customer Select suppliers, $0.25 per bill, because Nicor Solutions offers a product that may be considered to be in competition with the sale of gas by Customer Select suppliers. Nicor continued that, unlike Nicor Energy Services, neither Nicor Solutions nor the Customer Select suppliers have paid an initial programming fee or are subject to ongoing maintenance fees associated with this particular billing service.

Nicor also argued that its charge to Nicor Energy Services for billing service conforms with its Commission-approved Operating Agreement. Its Operating Agreement determines when Nicor must charge an affiliate the prevailing price for a service, and when it must charge the fully distributed cost for a service. The Operating Agreement defines the "prevailing price" as the "price for which the facility or service is provided for sale to the general public by the Provider." The Company notes that Staff witness Ms. Hathhorn agreed to this definition of "prevailing price" in the Operating Agreement. Tr. 461. When it does not offer a service to the general public, the Operating Agreement requires Nicor to charge an affiliate the fully distributed cost of providing the service. Staff witness Ms. Hathhorn also agreed that use of a fully distributed charge is appropriate where Nicor does not offer a service for sale to the general public. Tr. 468-469.

Nicor argued that the billing service it offers Nicor Energy Services is not provided for sale to the general public. It stated that the billing service is offered only to Nicor Energy Services - a fact Staff witness Hathhorn recognized. Nicor maintained that use of a fully distributed cost charge is appropriate, and, pursuant to the terms of the Operating Agreement, using the fully distributed cost for calculating the test year revenues attributable to the provision of billing service to Nicor Energy Services is reasonable. Nicor submitted that, in charging the fully distributed cost for the service, a charge that Staff does not contest, the ratepayers are not subsidizing the service. The Company concluded that customers are not negatively impacted by this charge, which is another point that Staff fails to address.

Nicor also contended that because the billing service it provides to Nicor Solutions also is offered to Customer Select suppliers pursuant to a Commission-approved tariff, the Operating Agreement requires that the Company charge Nicor Solutions the "prevailing rate." Nicor Solutions is assessed the $0.25 per bill charge, as it is the prevailing price for billing services offered to Customer Select suppliers under the Customer Select program.

3. The AG/CUB Position

The AG/CUB support the recommendation of Staff witness Hathhorn that the Commission adjust the Company's test year expenses for the cost of services billed by Nicor Gas to Nicor Energy Services. Ms. Hathhorn argued that the Company's billings to Nicor Energy Services should be charged at the prevailing rate for such services as required by its Operating Agreement and the practice of Nicor Energy Services with respect to other Nicor companies. AG/CUB maintained that the Commission should reduce the Company's operating expenses by $588,000. AG Initial Brief at 98.

4. Analysis and Conclusions

The Commission accepts the Company's argument and finds that it has properly charged the fully distributed cost of the billing service that it provides Nicor Energy Services. The billing service offered to Nicor Energy Services is different from the service offered to Nicor Solutions. The Company also does not offer to any other party the billing service provided to Nicor Energy Services. Further, under the present terms of the Company's Operating Agreement, use of a fully distributed charge is appropriate where the Company does not offer a service for sale to the general public. The Commission accepts the Company's calculation of test year revenues related to Nicor Energy Services billing service.

XV. GROSS REVENUE CONVERSION FACTOR

This matter was uncontested, except for the impact of the uncollectible percentage of revenue, which was in dispute. Nicor witness Mr. Gorenz agreed to exclude the State invested capital tax rate of 0.80% from the calculation of the Gross Revenue Conversion Factor, contingent upon reflection of the incremental state invested capital taxes as adjusted to operating expenses. Nicor Ex. 26.0 at 50. This results in a Gross Revenue Conversion Factor of 1.697816. Nicor Ex. 26.1 at. 2. Because we were not persuaded by the AG's position regarding Nicor's rate of uncollectible expense, no further adjustment is required. We therefore find that use of a Gross Revenue Conversion Factor of 1.697815 is reasonable.

XVI. OTHER ISSUES

A. ACCOUNTING FOR STORAGE GAS LOSSES

1. Staff's Position

Staff's recommendations regarding this issue do not result in any adjustments in this proceeding. They are prospective in nature. Staff contended that Nicor's methodology of adjusting its storage field inventories for physical gas losses and for the deterioration of storage field performance over time does not adequately reflect what was actually occurring at its storage fields. According to Staff, Nicor has not supported the use of a 2% adjustment factor for the withdrawal of gas volumes from Company-owned storage fields. Staff recommended that the Commission direct Nicor to discontinue the use of the blanket 2% loss factor for storage adjustments in the future. Instead, Staff recommended that the Commission direct Nicor to estimate the "physical losses" as they occur at each storage field and to determine its "performance variation" volumes via its Inventory Verification Studies, (its "IVS") only when precise measurement permits reliable results. Staff Ex. 9.0 at 10, 15. Staff recommended further that the Commission should direct Nicor to prospectively record "physical losses" in Account 823, and "performance variations" in Account 352.3, Nonrecoverable Natural Gas, to comply with the Uniform System of Accounts for Gas Utilities Operating in Illinois, 83 Ill. Adm. Code 505 (the "USOA").

Finally, Staff recommended that the Commission direct Nicor to provide the Director of the Energy Division and to the Manager of the Commission's Accounting Department with a copy of written procedures that address all of the above concerns within 60 days after a final Order is entered in this proceeding and to work with Staff to ensure the appropriate procedures are in place. Staff Initial Brief at 178-79.

2. Nicor's Position

Nicor averred that this matter is fully resolved. Its witness Mr. Bartlett testified that Nicor will transition from its current approach for accounting for storage gas losses no later than July 1, 2009. Nicor agreed to account for two types of storage gas losses, 1) "physical loss" and 2) losses not attributable to specific causes, consistent with the accounting procedures that Staff recommends. Nicor Ex. 45.0 at 13-14. Nicor further agreed to develop written procedures related to tracking these two types of losses and implement these procedures no later than July 1, 2009. Nicor Reply Brief at 12-28.

3. Analysis and Conclusions

We conclude that this matter is fully resolved. Nicor has agreed to implement all of the accounting changes that Staff recommended and it has agreed to develop written procedures regarding tracking these two types of losses and to implement those procedures no later than July 1, 2009, which is, approximately 90 days from the date when a final Order will issue in this docket. This is close to what Staff recommended (60 days). We direct Nicor to report its gas losses, in the future, in accordance with Staff's recommendations, set forth above. Also, Nicor should work with Staff when developing these procedures. Finally, Nicor shall serve a copy of those procedures upon the Director of the Energy Division and to the Manager of the Commission's Accounting Department as is expressed above herein, on or before July 1, 2009.

B. **REPORTING OF AFFILIATE TRANSACTIONS**

Staff witness Hathhorn proposed that the Company annually file a report of affiliate transactions as a Supplemental Schedule to Form 21 ILCC. Staff Ex. 2.0 at 35-36. Nicor witness Mr. Gorenz explained that the Company agrees with Staff's proposal, subject to particular reporting formats. Ms. Hathhorn accepted the suggested reporting formats. Staff Ex. 15.0 at 18. Staff recommended that the Commission order should include finding and ordering paragraphs directing Nicor, beginning May 1st 2009 for the 2008 reporting period, to file a Supplemental Schedule to Form 21 reporting the amount paid each year to each affiliate and the amount received each year from each affiliate. The Supplemental Schedule should also provide a description of the services provided or received, and a description of the method used to determine the amount of the charges. Staff Initial Brief at 190; Nicor Initial Brief at 135.

Analysis and Conclusion

The Commission finds that it is reasonable for the Company to file a report of affiliate transactions as a Supplemental Schedule to its Form 21 annual filing consistent with the above mentioned agreed upon format.

C. **OPERATING AGREEMENT**

This issue, also, has been resolved. Staff witness Hathhorn testified that due to concerns raised in discovery and testimony regarding Nicor's affiliated interest transactions, a proceeding should be initiated within 120 days of a final Order in this proceeding to investigate whether Nicor's Operating Agreement is in the public interest and make the appropriate revisions. According to Ms. Hathhorn, the proceeding, at a minimum, should investigate the following issues: 1) the criteria for when it is appropriate to apply the prevailing price and when it is appropriate to only charge fully distributed costs; 2) consideration of Nicor employees that are dedicated full-time to Nicor Gas' affiliates; 3) facilitation of affiliate endeavors through utility activities; and 4) annual reporting and auditing requirements to the Commission. Nicor stipulated that it does not oppose Staff's recommendation to investigate and revise its Operating Agreement for affiliated interest transactions. Nicor Reply Brief at 128.

Staff further recommended that the Commission Order include finding and ordering paragraphs directing Nicor to file a petition within 120 days of an order in this proceeding seeking either re-approval of its current Operating Agreement or approval of a new affiliated interest transaction agreement. Staff also contended that this petition should be supported by Company testimony in either scenario. Nicor has no objection to this proposal. *Id.*

Analysis and Conclusions

We find that the agreed-to proposal is reasonable and it is hereby approved. The Finding and Ordering Paragraphs shall contain language requiring Nicor to file a petition with supporting verified testimony that either seeks re-approval of its current Operating Agreement or seeks approval of a new affiliated interest transaction agreement. This Petition shall address the criteria expressed by Ms. Hathhorn, as is set forth above.

XVII. FINDING AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and, being fully advised in the premises, is of the opinion and finds that:

(1) the Northern Illinois Gas Company, doing business as Nicor Gas Company, is an Illinois corporation engaged in the storage, transmission, distribution and sale of natural gas to the public in Illinois and is a public utility as is defined in Section 3-105 of the Public Utilities Act;

(2) the Commission has subject-matter jurisdiction and jurisdiction over the parties;

(3) the recitals of fact and conclusions of law reached in the prefatory portion of this Order are supported by the evidence herein, and are hereby adopted as findings of fact and conclusions of law; the Appendix attached hereto provides the supporting calculations;

(4) the test year for the determination of the rates herein found to be just and reasonable should be the 12 months ending December 31, 2009; such test year is appropriate for purposes of this proceeding;

(5) for the test year ending December 31, 2009, and for the purposes of this proceeding, Nicor's rate base is $1,336,495,000;

(6) a just and reasonable return, which Nicor should be allowed to earn on its net original cost rate base is 7.58%;

(7) the rate of return set forth in Finding (6) results in base rate operating revenues of $616,262,000 and net annual operating income of $101,301,000, based on the test year approved herein;

(8) Nicor's rates, which are presently in effect are insufficient to generate the operating income necessary to permit it the opportunity to earn a fair and reasonable return on net original cost rate base; these rates should be permanently canceled and annulled;

(9) the specific rates proposed by Nicor in its initial filing do not reflect various determinations made in this Order regarding revenue requirement, cost of service allocations, and rate design; Nicor's proposed rates should be permanently canceled and annulled consistent with the findings herein;

(10) Nicor is authorized to place into effect tariff sheets designed to produce annual base rate revenues of $616,262,000, which represents a gross increase of $68,982,000, or 12.15%; such revenues will provide Nicor with an opportunity to earn the rate of return set forth in Finding (6) above; based on the record in this proceeding, this return is just and reasonable;

(11) the determinations regarding cost of service and rate design contained in the prefatory portion of this Order are reasonable for purposes of this proceeding; the tariffs filed by Nicor shall incorporate the rates and rate design set forth and referred to herein; and

(12) new tariff sheets authorized to be filed by this Order shall reflect an effective date of not less than three (3) days after the date of filing, with the tariff sheets to be corrected, if necessary, within that time period;

(13) Nicor shall, beginning May 1st 2009, for the 2008 reporting period, file a Supplemental Schedule to Form 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;

(14) Nicor shall file a petition within 120 days of the date of a final Order in this proceeding seeking either re-approval of its current Operating Agreement, or, approval of a new affiliated interest transaction agreement; this petition

shall address the criteria expressed by Staff, as is set forth in section XIV(C) herein; and, it shall be supported by verified testimony;

(15) a rulemaking docket shall commence within 60 days from the date of a final Order in this docket to establish standards for gas energy efficiency plans, as was set forth herein;

(16) Nicor shall provide on or before July 1, 2009, to the Director of the Commission's Energy Division and to the Manager of its Accounting Division, its procedures reflecting the discontinuance of the use of the blanket 2% loss factor for storage adjustments in the future, as well as other changes in related procedures that were discussed herein;

(17) Nicor shall perform any other task that the body of this Order requires it to do.

IT IS THERFORE ORDERED by the Illinois Commerce Commission that the tariff sheets presently in effect rendered by the Northern Illinois Gas Company are hereby permanently canceled and annulled, effective at such time as the new tariff sheets required by this order and approved herein become effective, by virtue of this Order.

IT IS FURTHER ORDERED that the proposed tariffs seeking a general rate increase, filed by the Northern Illinois Gas Company on April 29, 2008, are permanently canceled and annulled.

IT IS FURTHER ORDERED that the Northern Illinois Gas Company is authorized to file new tariff sheets, with supporting workpapers, in accordance with Findings (10), (11) and (12) of this Order, applicable to service furnished on and after the effective date of said tariff sheets.

IT IS FURTHER ORDERED that any motion, petitions, objections and other matters that remain unresolved are disposed of consistent with the conclusions herein.

IT IS FURTHER ORDERED that, subject to the language in Section 10-113 of the Public Utilities Act and in 83 Ill. Adm. Code 200.880, this Order is final; it is not subject to the Administrative Review Law.

IT IS FURTHER ORDERED that Nicor shall, beginning May 1st 2009 for the 2008 reporting period, file a Supplemental Schedule to Form 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.

IT IS FURTHER ORDERED that Nicor shall file a petition within 120 days of the date of a final Order in this proceeding seeking either re-approval of its current Operating Agreement, or, approval of a new affiliated interest transaction agreement; this petition shall address the criteria expressed by Staff, as is set forth in Section XIV(C) herein; and, it shall be supported by verified testimony.

IT IS FURTHER ORDERED that a rulemaking docket shall commence within 60 days from the date of a final Order in this docket to establish standards for gas energy efficiency plans, as was set forth herein.

IT IS FURTHER ORDERED that Nicor shall provide on or before July 1, 2009, to the Director of the Commission's Energy Division and to the Manager of its Accounting Division, its procedures reflecting the discontinuance of the use of the blanket 2% loss factor for storage adjustments in the future, as well as other changes in related procedures that were discussed herein.

IT IS FURTHER ORDERED that Nicor shall perform any task that the body of this Order requires it to do.

By Order of the Commission this 25th day of March, 2009.

(SIGNED) CHARLES E. BOX

Chairman