# STATE OF ILLINOIS

# ILLINOIS COMMERCE COMMISSION

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| NORTH SHORE GAS COMPANY | : | |
| | : | No. 09-____ |
| Proposed General Increase | : | |
| In Rates For Gas Service | : | |

Direct Testimony of

**JAMES F. SCHOTT**

Vice President – Regulatory Affairs,
Integrys Energy Group, Inc., and North Shore Gas Company

On Behalf of
North Shore Gas Company

February 13, 2009

**PUBLIC VERSION**

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# I. INTRODUCTION AND BACKGROUND

## A. Witness Introduction

Q. Please state your name and business address.

A. My name is James F. Schott. My business address is 130 E. Randolph Drive, Chicago, Illinois 60601.

Q. Mr. Schott, by whom are you employed and in what capacity?

A. I am the Vice President – Regulatory Affairs of the Integrys Energy Group, Inc. ("Integrys"), as well as for North Shore Gas Company ("North Shore").

Q. On whose behalf are you offering this testimony?

A. I am offering this testimony on behalf of North Shore.

## B. Purpose of Testimony

Q. What is the purpose of your direct testimony?

A. The purpose of my direct testimony is to address the reasons North Shore finds it necessary to request a rate increase in these challenging economic times. In addition, I will summarize the reasons for rate design and tariff changes, including the Rider proposals in this rate filing.

## C. Summary of Conclusions

Q. Please summarize the conclusions of your direct testimony regarding the need for a rate increase.

A. North Shore's previous rate case was based on an adjusted historical test year ended September 30, 2006. This request is based on a forward looking test year ending

December 31, 2010, for rates that will be effective January 2010. There have been significant changes over those four-plus years, including additional investment in plant, enhancements to the work force, changes in the cost of capital due to events in the financial markets, and increased costs of operations. These changes and their attendant costs would not be reflected in 2010 rates without the rate relief sought in this filing.

Q. Please summarize your conclusions regarding the need for rate design changes sought in this filing.

A. North Shore is seeking the approval of three riders in this rate case, an Uncollectible Expense Adjustment rider ("Rider UEA"), which applies to sales customers and would recover the gas cost related Account No. 904 Uncollectible Accounts expenses, a Franchise Cost Adjustment Rider ("Rider FCA"), and a Governmental Agency Compensation Adjustment Rider ("Rider GCA").

Rider UEA is required as uncollectibles expenses are significant, volatile, and difficult to predict much less control in any economic environment, due mainly to the volatility of natural gas prices. For example, actual calendar 2008 uncollectible expense jumped to [CONFIDENTIAL AND PROPRIETARY ("CONF. & PROP.") END CONF. & PROP.] from $2,090,000 in calendar 2007, an increase of [CONF. & PROP. END CONF. & PROP.]. More significantly, calendar 2008 net write-offs jumped to [CONF. & PROP. END CONF. & PROP.] from $1,637,000 in calendar 2007, an increase of [CONF. & PROP. END CONF. & PROP.]. Thus, uncollectibles expenses meet the most common grounds for rider recovery.

Both Rider FCA and Rider GCA are required to properly allocate actual costs generated by a governmental unit to the customers who reside within the geographic boundaries of the governmental unit's area. Rider FCA would allocate actual costs arising from franchise agreements with governmental units while Rider GCA would allocate costs arising from specific actions or rules imposed by governmental units. Both riders would more appropriately allocate the costs to those customers who reside in the area of the cost causers, rather than to all North Shore Gas customers.

Finally, North Shore proposes changes to its rate design that will better align rates with the appropriate cost drivers.

Q. Mr. Schott, how can North Shore ask the Illinois Commerce Commission (the "Commission") to increase rates for North Shore's customers when those customers are facing these challenging economic times?

A. North Shore understands and appreciates the extraordinary challenges our customers are facing and realizes the Commission must be cognizant of the impact of rate changes on our customers. However, North Shore's costs of providing safe, adequate and reliable service have increased significantly, for a number of reasons, as discussed later in my testimony and as is detailed and supported by the testimony of other witnesses. For a utility to experience large cost recovery shortfalls is not in the long term interests of customers. Such a situation simply is not sustainable. Moreover, large cost recovery shortfalls deny a fair return to investors and therefore will increase the utility's costs of capital over time. North Shore would not be seeking this rate relief unless it believed that it was necessary for the continued ability of this company to provide safe, adequate, and reliable service and to do so at the least long term cost.

Furthermore, since the test year forecast used in this rate case was prepared, North Shore, in light of the economic crisis, has undertaken an extraordinary effort to reduce current and future costs. In rebuttal testimony, North Shore will detail changes to the revenue requirement it proposes as a result of decisions made between the time the revenue requirement in this filing was developed and the time of its rebuttal testimony. Those changes can then be reflected in the final rates resulting from this docket.

## D. Background and Experience

Q. Mr. Schott, please describe your education and business experience.

A. I am a 1979 graduate of Georgetown University with a Bachelor of Science in Business Administration. I received a Masters in Business Administration from the University of Wisconsin – Milwaukee in 1993. I was employed by Arthur Andersen & Co. from 1979 to 1990, specializing in public utility taxation and ratemaking. From 1990 through 2002, I was employed by Wisconsin Gas Company in various finance and operating responsibilities. From 1998 to 2002, I was Senior Vice President of Wisconsin Gas Company with responsibility for all utility operations. I was also responsible for the gas operations of Wisconsin Electric Power Company, an affiliate of Wisconsin Gas Company from 2000 to 2002. I have served as Vice President - Regulatory Affairs of Wisconsin Public Service Company ("WPSC") since January 2003. Upon the formation of Integrys, I became Vice President - Regulatory Affairs of Integrys and Vice President - Regulatory Affairs of North Shore. I am a licensed Certified Public Accountant in the State of Wisconsin.

Q. Please describe your current duties and responsibilities.

A. My responsibilities include all regulatory and rate matters for all jurisdictions for the regulated businesses of Integrys. I also serve on the board of directors of Integrys' regulated natural gas subsidiaries, North Shore, The Peoples Gas Light and Coke Company ("Peoples Gas"), Michigan Gas Utilities Corporation, and Minnesota Energy Resources Corporation.

Q. Have you ever testified before the Commission?

A. Yes. I testified in ICC Docket Nos. 07-0241 and 07-0242 Consolidated, the last base rate increase for North Shore and Peoples Gas. I have also testified in numerous rate-related dockets before the Public Service Commission of Wisconsin

## II. <u>SUMMARY OF NORTH SHORE'S NEED FOR RATE RELIEF</u>

### A. <u>Overview</u>

Q. Please give a brief description of the operations of North Shore.

A. North Shore is engaged in the business of transporting, purchasing, storing, distributing and selling natural gas at retail to approximately 158,000 residential, commercial, and industrial customers within fifty-four communities in Lake and Cook Counties, Illinois. The service territory covers an area of approximately 275 square miles. The company owns a 2,350 mile distribution system. North Shore employs approximately 170 people. North Shore is a wholly-owned subsidiary of Peoples Energy Corporation, which in turn is a wholly-owned subsidiary of Integrys.

### B. <u>Identification of Other Witnesses Providing Direct Testimony</u>

Q. Please identify the witnesses presenting direct testimony in support of North Shore's filing and the main topic or topics that each witness addresses.

A. The following witnesses are providing direct testimony on behalf of North Shore:

- Christine M. Gregor, Director, Operations Accounting, North Shore (North Shore Ex. CMG-1.0), presents the operating income statement for the forecasted calendar test year 2010, including projected costs. She discusses variances in operating expenses from the test year to 2007. She also discusses the methodology used in the preparation of the operating income statement for the test year, certain ratemaking adjustments, and certain compliance matters.
- Sharon Moy, Rate Case Consultant, Integrys Business Support (North Shore Ex. SM-1.0), addresses the test year revenue requirement, operating income and expenses, the adjustments to operating income and expenses, and the Gross Revenue Conversion Factor.
- David W. Clabots, Manager, Sales and Revenue Forecasting, Integrys Business Support (North Shore Ex. DWC-1.0), will explain how the customer demand forecast was derived for the 2010 test year. He will also compare demand between North Shore's forecasted 2010 test year and North Shore's last historical year (2008) (using six months of actual results).
- Michael A Small, Assistant Controller of Financial and Accounting Services of Integrys Business Support (North Shore Ex. MAS-1.0), addresses the effects of various affiliated interest agreements on North Shore's revenue requirement.
- Paul R. Moul, Managing Consultant, P. Moul & Associates (North Shore Ex. PRM-1.0), addresses the required rate of return on common equity for North Shore.

- Bradley A. Johnson, Treasurer, North Shore, (North Shore Ex. BAJ-1.0), addresses the capital structure and cost of capital (its overall required rate of return on its investments) for North Shore.
- Valerie H. Grace, Manager, Gas Regulatory Services of Integrys Business Support (North Shore Ex. VG-1.0), addresses and supports the proposed rate design for North Shore and the three new riders North Shore is proposing, the Rider UEA, Rider FCA and Rider GCA. She also addresses and supports changes to the Schedule of Rates for Gas Service for North Shore.
- Brian M. Marozas, Manager, Planning, Modeling and Contract Administration, Integrys Business Support (North Shore Ex. BMM-1.0), explains how he developed the forecast of normal heating degree days for North Shore using an historical 12 year average.
- John Hengtgen, Rate Case Consultant, Integrys Business Support (North Shore Ex. JH-1.0), describes the rate base, adjustments to rate base, and the cash working capital components of the request of North Shore for a general increase in rates.
- John J. Spanos, Vice President, Valuation and Rate Division, Gannett Fleming, Inc. (North Shore Ex. JJS-1.0), presents North Shore's new depreciation study.
- Joylyn C. Hoffman Malueg, Rate Case Consultant, Integrys Business Support (North Shore Ex. JCHM-1.0), describes North Shore's embedded cost of service study for the 2010 future test year used by Ms. Grace in the proposed changes in the North Shore rate schedules addressed in Ms. Grace's testimony.

- Edward Doerk, Vice President Gas Operations, North Shore (North Shore Ex. ED-1.0), addresses certain major additions to rate base since the last test year. Mr. Doerk also describes North Shore's forecasted capital investments.

**C. <u>Need For Rate Relief</u>**

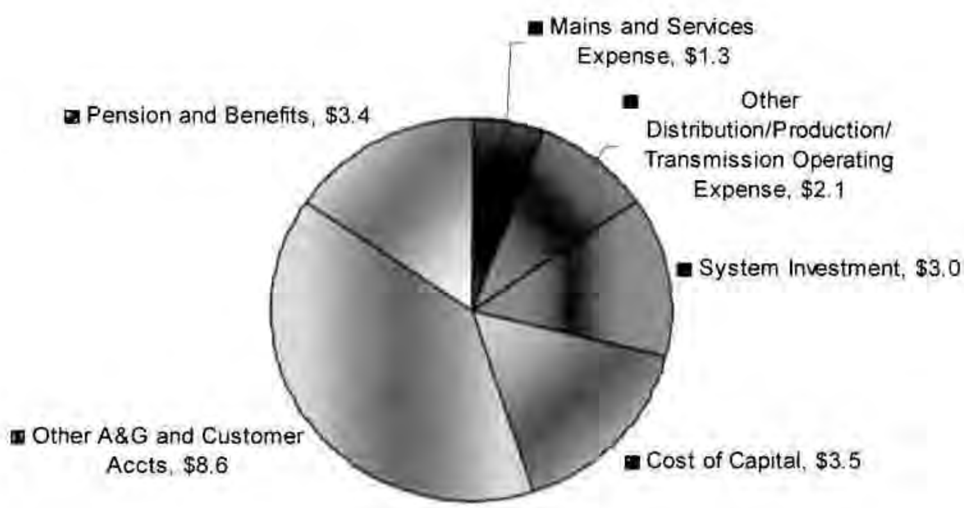
Q. Why does North Shore need the rate relief requested to go into effect in January 2010 after having received rate relief in February 2008?

A. The rate relief North Shore received last year was based an adjusted historical test year of fiscal 2006 ending in September 30, 2006. This rate filing is based on a forward looking 2010 test year. There is a difference of over four years between the test year our current rates are based on and when our new rates would become effective in January 2010. During this period, North Shore has invested significant capital and has experienced significant increased operating costs. Also, the cost of capital has increased significantly for North Shore. These factors combine to drive the need for rate relief. Based on revenues and costs contained in this filing, without the requested relief, North Shore would earn a return on equity of only 1.1%, compared to the 9.99% approved in its last rate case and its current cost of equity of 12.00%.

Q. Please summarize the changes in North Shore's expenditures over those four-plus years and how they drive a need for additional rate relief.

A. I refer to the pie chart below which graphically describes the changes in our costs since the last test year. The first four categories, Mains and Services Expense ($1.3 million), Other Distribution Expense ($2.1 million), System Capital Investment ($3.0 million) (holding the rate of return approved in the last rate case constant) and Cost of Capital ($3.5 million), together make up almost half of the increase. These are the costs we incur to maintain, replace, upgrade, and finance the pipe in the ground. The other half of the increase is for back office type expenses, including customer service expense, such as the call center, as well as administrative costs and employee benefits.

## Rate Relief Drivers 2006-2010 (in millions)




Q. Please describe these categories in more detail and what is driving the increases in these categories.

A. The first two categories, Mains and Services Expense ($1.3 million) and Other Distribution and Storage Expense ($2.1 million) are the non-capitalized costs we incur to operate and maintain our underground distribution system. As Ms. Gregor explains in more detail in her testimony, the increase in these items is generally attributable to increased costs resulting from the transmission pipeline integrity program, additional head count and increased transportation costs.

The third category, System Capital Investment ($3.0 million) represents the return on and return of capital invested since the prior rate case, primarily in the underground distribution and storage system, holding the rate of return approved in the last rate case constant. A primary driver for this category is North Shore's ongoing significant investment in its distribution system. Also included is the impact of a change in the method used to account for the net dismantling costs incurred when plant is retired. As Ms. Gregor notes, Peoples Gas and North Shore are two of the few distribution utilities in the country to continue to use the current method of recovering these costs when incurred at the end of the life of the asset rather than over the life of the asset. The ratemaking adjustment proposes to change to the more universally used method. Again, these costs are more fully explained in Ms. Gregor's and Mr. Doerk's testimony.

The fourth category, Cost of Capital ($3.5 million), represents the increased cost of long-term debt and common equity for North Shore since the last rate case. The overall cost of capital is the required return on the investment of North Shore (net of depreciation) in its assets, primarily distribution pipe. In order to attract capital for new investments, existing investors must receive an adequate return on their investment. As discussed in Mr. Moul's and Mr. Johnson's testimony, the events that have shaken the financial markets since the last rate case have, among other things, increased the cost of capital for businesses throughout the world and North Shore is no exception.

The fifth category, Administrative and General and Customer Accounts ($8.6 million), represent increases in costs associated with "back office" operations, including billing, collection, call center, as well as support functions such as human resources, finance and accounting, information systems, etc. Most of these costs are now provided by Integrys Business Support. The primary drivers in the increases to these costs are inflation and increased administrative requirements. In addition, given the formation of Integrys Business Support, there is a cost shift from Peoples Gas to North Shore due to refinement of cost allocation factors. Also, it must be noted that under the Commission's order in the WPS Resources Corporation/Peoples Energy Corporation merger docket (ICC Docket No. 06-0540), synergy savings are reflected in North Shore's current rates.

The sixth category, Pensions and Benefits ($3.4 million), is due to the movement of intercompany costs out of Account 923 and into the various accounts that they would have been recorded to had that transaction happened on the utility and changes in plan assumptions (primarily a change in the pension and benefits discount rate and a change in the medical trend rate).

Q. Have these increased costs prevented North Shore from earning its authorized return since its last rate case?

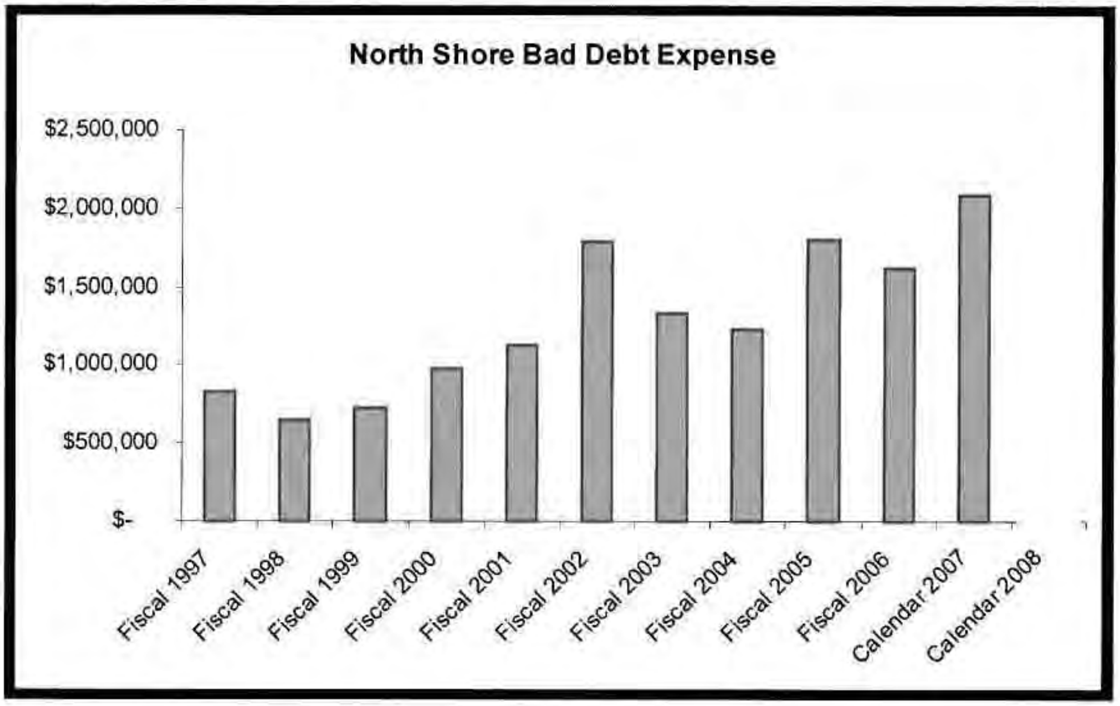
A. Yes. In 2008, even though the new rates went into effect on February 14, 2008, North Shore earned a return on common equity of [CONF. & PROP. END CONF. & PROP.] as opposed to an authorized return on common equity of 9.99%. Without adequate rate relief, returns will continue to fall below North Shore's cost of equity. As shown in Mr. Johnson's testimony, without rate relief North Shore will earn a return on equity of only 1.1% in 2010, based on the financial information presented in this rate case. To repeat, failure to recover costs fully, including earning an adequate return, is not sustainable and results in higher costs for future ratepayers through a higher cost of capital.

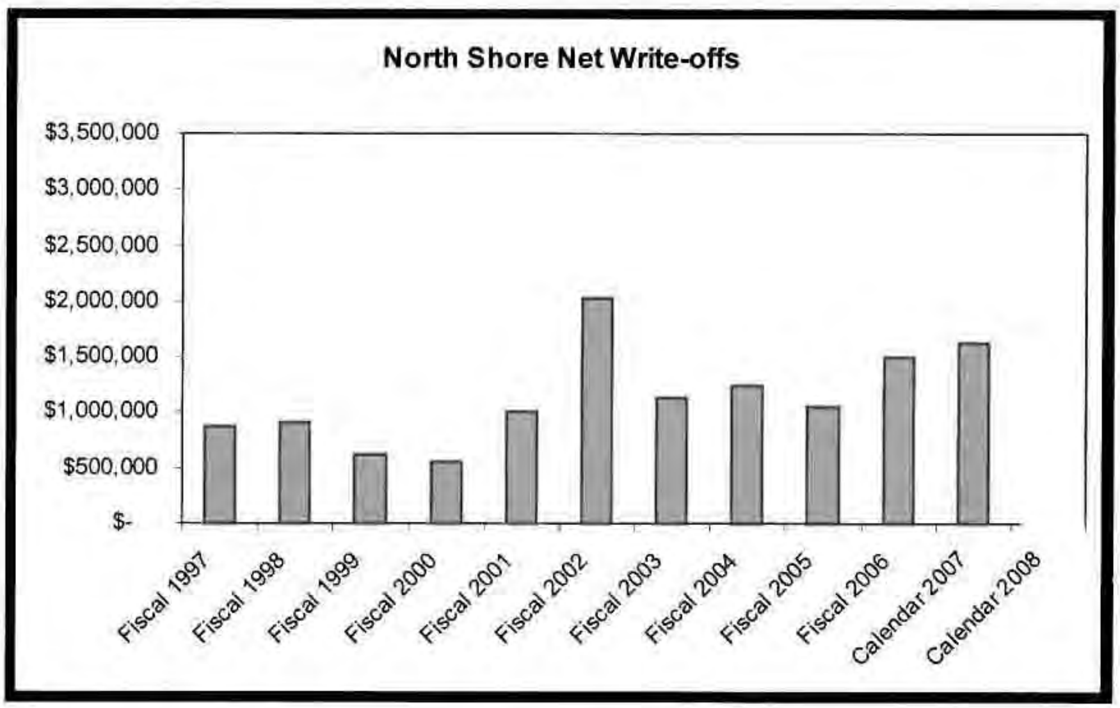
## III. RIDER PROPOSALS

### A. Rider UEA (Uncollectible Expense Adjustment)

Q. Please discuss the need for Rider UEA.

A. The increased need for an uncollectibles rider like Rider UEA, which applies to sales customers (only) and recovers the gas cost related amounts in Account 904 (Uncollectible Accounts), is driven by volatility in gas costs and the current financial conditions and is especially important given the challenging economic circumstance of the service territory of North Shore. Economic turbulence can exacerbate the volatility and unpredictability of uncollectibles. As noted above, actual calendar 2008 uncollectible expense jumped to [CONF. & PROP. END CONF. & PROP.] from $2,090,000 in calendar 2007, an increase of [CONF. & PROP. END CONF. & PROP.]. Furthermore, calendar 2008 net write-offs jumped to [CONF. & PROP. END CONF. & PROP.] from $1,637,000 in calendar 2007, an increase of [CONF. & PROP. END CONF. & PROP.]. The tables below further illustrate the year to year volatility of North Shore's uncollectible expenses and net write offs. [CONF. & PROP. (AS TO 2008 DATA)

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Thus, uncollectibles expenses meet the most common grounds for rider recovery.

### B. Rider FCA (Franchise Cost Adjustment) and <u>Rider GCA (Governmental Agency Compensation Adjustment)</u>

Q. Please describe the need for Rider FCA and Rider GCA.

A. Both Rider FCA and Rider GCA are required to properly allocate actual costs generated by a governmental unit to the customers who reside within the geographic boundaries of the governmental unit's area. As described above, Rider FCA would allocate actual costs arising from franchise agreements with governmental units, while Rider GCA would allocate costs arising from specific actions or rules imposed by governmental units. Both riders would more appropriately allocate the costs to those customers who reside in the area of the cost causers, rather than to all North Shore Gas customers.

## IV. <u>RIDER EEP (ENHANCED EFFICIENCY PROGRAM)</u>

Q. Please discuss the status of the Enhanced Efficiency Program for North Shore.

A. In ICC Docket No. 07-0741, the Commission authorized North Shore to recover \$1.1 million annually for the Enhanced Efficiency Program it proposed in the testimony of Ms. Rukis. North Shore has implemented the program and the Governance Board, made up of representatives of North Shore, the Attorney General of the State of Illinois, the City of Chicago, the Citizens Utility Board, and the Environmental Law and Policy Center, has taken ownership of the program. It has since been rebranded to the Chicagoland Natural Gas Savings Program.

Several programs were started in late 2008 and early 2009, such as rebates for high efficiency equipment and weatherization, including a low income component. Given the short period these programs have been in place, it would be premature to report further at this time on the status of those programs. We will provide a more detailed report when more data are available in our rebuttal testimony.

Q. Are there any special circumstances surrounding the timing of this filing or, given the timing of this filing, when any subsequent newly approved rates would take effect?

A. In ICC Docket No. 06-0540 (the "Merger Docket"), Peoples Gas and North Shore indicated they would not file a second rate case with an effective date earlier than January 1, 2010[1].

Specifically, in that case, People Gas and North Shore agreed that they would file rate cases in early 2007 based on historical test years (with defined adjustment for merger related synergies and costs to achieve) that would result in rates effective in early 2008. Those rate cases have already occurred. Peoples Gas and North Shore further agreed in the Merger Docket they would not file for additional rate increases until 2009 at the earliest, for rates to be effective in 2010. (Order in ICC Docket No. 06-0540, pp. 41-42).

Peoples Gas and North Shore reiterate that position in this proceeding. If the Commission did not act during the initial 45 days after the filing (or during the subsequent suspension periods per Section 9-201 of the Public Utilities Act) to suspend the tariffs, because of the aforementioned agreed-upon merger condition, North Shore would not implement any rate increase under this docket prior to January 1, 2010. The effective date provisions of the filed tariffs are consistent with this position.

Q. Does this conclude your direct testimony?

[1] "Applicants further state that they will not file for further general rate increases for the Gas Companies until at least 2009, to take effect in 2010." See ICC Docket No. 06-0540, Commission Order, February 7, 2007, at p.10 (quoting Merger Application at pps. 18-19).

A. Yes.