

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

THE PEOPLES GAS LIGHT	:	
AND COKE 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 The Peoples Gas
Light and Coke Company

On Behalf of
The Peoples Gas Light and Coke Company

February 13, 2009

PUBLIC VERSION

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1 I. **INTRODUCTION AND BACKGROUND**

2 A. **Witness Introduction**

3 Q. Please state your name and business address.

4 A. My name is James F. Schott. My business address is The Peoples Gas Light and Coke
5 Company (“Peoples Gas”), 130 E. Randolph Drive, Chicago, Illinois 60601.

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

7 A. I am the Vice President – Regulatory Affairs of the Integrys Energy Group, Inc.
8 (“Integrys”), as well as for Peoples Gas.

9 Q. On whose behalf are you offering this testimony?

10 A. I am offering this testimony on behalf of Peoples Gas.

11 B. **Purpose of Testimony**

12 Q. What is the purpose of your direct testimony?

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

17 C. **Summary of Conclusions**

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

20 A. Peoples Gas’ previous rate case was based on an adjusted historical test year ended
21 September 30, 2006. This request is based on a forward looking test year ending

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

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

30 A. Peoples Gas is seeking the approval of two riders in this rate case, an Infrastructure Cost
31 Recovery rider (“Rider ICR”), which would provide for the timely recovery of certain
32 costs of cast and ductile iron gas main replacement, and an Uncollectible Expense
33 Adjustment rider (“Rider UEA”), which applies to sales customers and would recover the
34 gas cost related Account No. 904 Uncollectible Accounts expenses. These riders address
35 some of the same concerns as did certain riders that Peoples Gas proposed in its last rate
36 case. Given the current economic situation, these riders are more critical than ever.

37 Rider ICR is important for the infrastructure of the City of Chicago and the jobs it
38 will create. The majority of Peoples Gas’ distribution system is still a low-pressure
39 system that is a legacy from the company’s origins of manufacturing gas from coal
40 primarily for use as lighting. Furthermore, almost half of Peoples Gas’ pipe is cast or
41 ductile iron, some of it installed over 100 years ago. This aging system poses significant
42 operations and maintenance as well as risk management burdens. While Peoples Gas
43 presently operates its distribution system safely, upgrading it to a medium-pressure
44 system comprised of state-of-the-art materials will provide increased safety, reliability,

45 environmental-friendliness and functionality for ratepayers. Moreover, accelerating
46 Peoples Gas' infrastructure replacement program will create many opportunities for new
47 jobs.

48 While it is important to continue to improve Peoples Gas' infrastructure and
49 create jobs, it is equally important to ensure that the expenditures for these improvements
50 are financed at a reasonable cost and consistent with the utility's financial condition and
51 capital needs. The expenditures can be financed at a reasonable cost with prompt and fair
52 rate recovery of the expenditures such as would be provided by Rider ICR. If Peoples
53 Gas is unable to finance these expenditures at a reasonable cost, they will create an
54 unnecessary financial burden for future generations of our customers through higher cost
55 of capital.

56 Rider UEA is required as uncollectibles expenses are significant, volatile, and
57 difficult to predict much less control in any economic environment, due mainly to the
58 volatility of natural gas prices. For example, actual calendar 2008 uncollectibles expense
59 jumped to [CONFIDENTIAL ("CONF. & PROP.") END CONF. &
60 PROP.] from \$33.0 million in calendar 2007, an increase of [CONF. & PROP.
61 END CONF. & PROP.]. Furthermore, calendar 2008 net write-offs
62 jumped to [CONF. & PROP. END CONF. & PROP.] from \$32.4 million in
63 calendar 2007, an increase of [CONF. & PROP. END CONF. &
64 PROP.]. Thus, uncollectibles expenses meet the most common grounds for rider recovery.

65 Finally, Peoples Gas proposes changes to its rate design that will better align rates
66 with the appropriate cost drivers.

67 Q. Mr. Schott, how can Peoples Gas ask the Illinois Commerce Commission (the
68 “Commission”) to increase rates for Peoples Gas’ customers when those customers are
69 facing these challenging economic times?

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

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

87 **D. Background and Experience**

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

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

102 Q. Please describe your current duties and responsibilities.

103 A. My responsibilities include all regulatory and rate matters for all jurisdictions for the
104 regulated businesses of Integrys. I also serve on the board of directors of Integrys’
105 regulated natural gas subsidiaries, Peoples Gas, North Shore Gas Company (“North
106 Shore”), Michigan Gas Utilities Corporation, and Minnesota Energy Resources
107 Corporation.

108 Q. Have you ever testified before the Commission?

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

112 **II. SUMMARY OF PEOPLES GAS' NEED FOR RATE RELIEF**

113 **A. Overview**

114 Q. Please give a brief description of the operations of Peoples Gas.

115 A. Peoples Gas is engaged in the business of transporting, purchasing, storing, distributing
116 and selling natural gas at retail to approximately 850,000 residential, commercial, and
117 industrial customers within the City of Chicago. This service territory covers an area of
118 about 237 square miles and has a population of approximately three million people.
119 Peoples Gas employs approximately 1,100 people, all within the City of Chicago.
120 Peoples Gas is a wholly-owned subsidiary of Peoples Energy Corporation, which in turn
121 is a wholly-owned subsidiary of Integrys.

122 **B. Identification of Other Witnesses Providing Direct Testimony**

123 Q. Please identify the witnesses presenting direct testimony in support of Peoples Gas' filing
124 and the main topic or topics that each witness addresses.

125 A. The following witnesses are providing direct testimony on behalf of Peoples Gas:

- 126 • Christine M. Gregor, Director, Operations Accounting, Peoples Gas (Peoples Gas
127 Ex. CMG-1.0), presents the operating income statement for the forecasted
128 calendar test year 2010, including projected costs. She discusses variances in
129 operating expenses from the test year to 2007. She also discusses the
130 methodology used in the preparation of the operating income statement for the
131 test year, certain ratemaking adjustments, and certain compliance matters.
- 132 • Sharon Moy, Rate Case Consultant, Integrys Business Support (Peoples Gas
133 Ex. SM-1.0), addresses the test year revenue requirement, operating income and

134 expenses, the adjustments to operating income and expenses, and the Gross
135 Revenue Conversion Factor.

136 • David W. Clabots, Manager, Sales and Revenue Forecasting, Integrys Business
137 Support (Peoples Gas Ex. DWC-1.0), will explain how the customer demand
138 forecast was derived for the 2010 test year. He will also compare demand
139 between Peoples Gas' forecasted 2010 test year and Peoples Gas' last historical
140 year (2008) (using six months of actual results).

141 • Michael A Small, Assistant Controller of Financial and Accounting Services of
142 Integrys Business Support (Peoples Gas Ex. MAS-1.0), addresses the effects of
143 various affiliated interest agreements on Peoples Gas' revenue requirement.

144 • Paul R. Moul, Managing Consultant, P. Moul & Associates (Peoples Gas
145 Ex. PRM-1.0), addresses the required rate of return on common equity for
146 Peoples Gas.

147 • Bradley A. Johnson, Treasurer, Peoples Gas, (Peoples Gas Ex. BAJ-1.0),
148 addresses the capital structure and cost of capital (its overall required rate of
149 return on its investments) for Peoples Gas.

150 • Valerie H. Grace, Manager, Gas Regulatory Services of Integrys Business
151 Support (Peoples Gas Ex. VG-1.0), addresses and supports the proposed rate
152 design for Peoples Gas and the two new riders Peoples Gas is proposing,
153 Rider ICR and Rider UEA. She also addresses and supports changes to the
154 Schedule of Rates for Gas Service for Peoples Gas.

155 • Brian M. Marozas, Manager, Planning, Modeling and Contract Administration,
156 Integrys Business Support (Peoples Gas Ex. BMM-1.0), explains how he

157 developed the forecast of normal heating degree days for Peoples Gas using an
158 historical 12 year average.

159 • Thomas L. Purrachio, Manager Gas Storage, Integrys Business Support (Peoples
160 Gas Ex. TLP-1.0), supports the investment of Peoples Gas in the Manlove storage
161 system since the last rate case.

162 • John Hengtgen, Rate Case Consultant, Integrys Business Support (Peoples Gas
163 Ex. JH-1.0), describes the rate base, adjustments to rate base, and the cash
164 working capital components of the request of Peoples Gas for a general increase
165 in rates.

166 • John J. Spanos, Vice President, Valuation and Rate Division, Gannett Fleming,
167 Inc. (Peoples Gas Ex. JJS-1.0), presents Peoples Gas' new depreciation study.

168 • Joylyn C. Hoffman Malueg, Rate Case Consultant, Integrys Business Support
169 (Peoples Gas Ex. JCHM-1.0), describes Peoples Gas' embedded cost of service
170 study for the 2010 future test year used by Ms. Grace in the proposed changes in
171 the Peoples Gas rate schedules addressed in Ms. Grace's testimony.

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

175 • Salvatore D. Marano, P.E., Managing Director, Jacobs Consultancy Inc. (Peoples
176 Gas Ex. SDM-1.0), provides evidence and analysis in support of the accelerated
177 infrastructure replacement program for Peoples Gas.

178 **C. Need For Rate Relief**

179 Q. Why does Peoples Gas need the rate relief requested to go into effect in January 2010
180 after having received rate relief in February 2008?

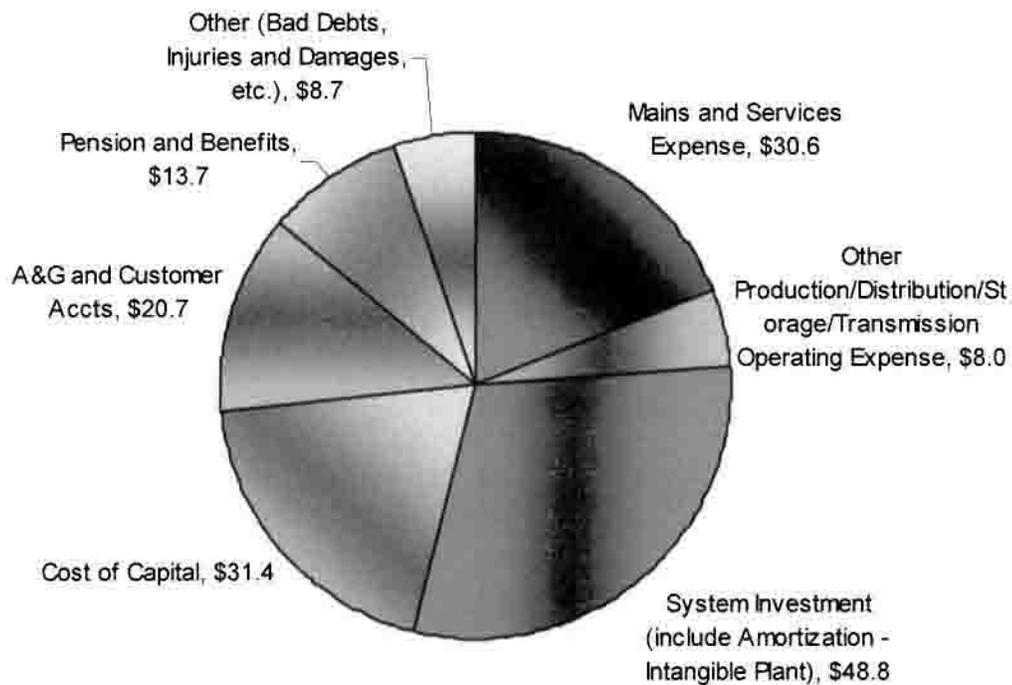
181 A. The rate relief Peoples Gas received last year was based on an adjusted historical test
182 year of fiscal 2006 ending in September 30, 2006. This rate filing is based on a forward
183 looking calendar 2010 test year. There is a difference of over four years between the
184 adjusted test year on which our current rates are based and when our new rates would
185 become effective in January 2010. During this period, Peoples Gas has invested
186 significant capital and has experienced significant increased operating costs. Also, the
187 cost of capital has increased significantly for Peoples Gas. These factors combine to
188 drive the need for rate relief. Based on revenues and costs contained in this filing,
189 without the requested relief, Peoples Gas would earn a return on equity of only 0.3%,
190 compared to the 10.19% approved in its last rate case and its current cost of equity of
191 12.00%.

192 Q. Please summarize the changes in Peoples Gas' expenditures over those four-plus years
193 and how they drive a need for additional rate relief.

194 A. I refer to the pie chart below which graphically describes the changes in our costs since
195 the last test year. The first four categories, Mains and Services Expense (\$30.6 million),
196 Other Distribution and Storage Expense (\$8.0 million), System Capital Investment (\$48.8
197 million) (holding the rate of return approved in the last rate case constant) and Cost of
198 Capital (\$31.4 million), together make up three-quarters of the increase. These are the
199 costs we incur to maintain, replace, upgrade, and finance the pipe in the ground. One

200 quarter of the increase is for back office type expenses, including customer service
201 expense, such as the call center, as well as administrative costs and employee benefits.

Rate Relief Drivers 2006-2010 (\$ in millions)



202

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

205 A. The first two categories, Mains and Services Expense (\$30.6 million) and Other
206 Distribution and Storage Expense (\$8.0 million) are the non-capitalized costs we incur to
207 operate and maintain our underground distribution system. As Ms. Gregor explains in
208 more detail in her testimony, the increase in these items is generally attributable to
209 increases in street restoration costs due to mandates from the City of Chicago, increased

210 costs resulting from a pipeline safety audit mandated by the Commission, and increased
211 transportation costs.

212 The third category, System Capital Investment (\$48.8 million) represents the
213 return on and return of capital invested since the prior rate case, primarily in the
214 underground distribution and storage system, holding the rate of return approved in the
215 last rate case constant. A primary driver for this category is Peoples Gas' ongoing
216 significant investment in its distribution system. This category also includes the costs to
217 retire and replace cast and ductile iron main under the current replacement plan. Also
218 included are additional similar costs resulting from our acceleration of the cast and
219 ductile iron main replacement. Again, these costs are more fully explained in
220 Ms. Gregor's and Mr. Doerk's testimony.

221 The fourth category, Cost of Capital (\$31.4 million), represents the increased
222 costs of long-term debt and common equity for Peoples Gas since the last rate case. The
223 overall cost of capital is the required return on the investment of Peoples Gas (net of
224 depreciation) in its assets, primarily distribution pipe and storage facilities. In order to
225 attract capital for new investments, existing investors must receive an adequate return on
226 their investment. As discussed in Mr. Moul's and Mr. Johnson's testimony, the events
227 that have shaken the financial markets since the last rate case have, among other things,
228 increased the cost of capital for businesses throughout the world and Peoples Gas is no
229 exception.

230 The fifth category, Administrative and General and Customer Accounts
231 (\$20.7 million), represent the increases in costs associated with "back office" operations,
232 including billing, collection, call center, as well as support functions such as human

233 resources, finance and accounting, information systems, etc. Most of these costs are now
234 provided by Integrys Business Support. The primary drivers in the increases to these
235 costs are inflation and increased administrative requirements. It must be noted that under
236 the Commission's order in the WPS Resources Corporation/Peoples Energy Corporation
237 merger docket (ICC Docket No. 06-0540), synergy savings are reflected in Peoples Gas'
238 current rates.

239 The sixth category, Pensions and Benefits (\$13.7 million) is due to the movement
240 of intercompany costs out of Account 923 and into the various accounts that they would
241 have been recorded to had that transaction happened on the utility and changes in plan
242 assumptions (primarily a change in the pension and benefits discount rate and a change in
243 the medical trend rate).

244 The seventh category, Other costs (\$8.7 million) is made up primarily of bad debt
245 expense, injuries and damages expense, and taxes other than income taxes.

246 Q. Have these increased costs prevented Peoples Gas from earning its authorized return
247 since its last rate case?

248 A. Yes. In 2008, even though the new rates went into effect on February 14, 2008, Peoples
249 Gas earned a return on common equity of **[CONF. & PROP.]** **END CONF. &**
250 **PROP.]** as opposed to an authorized return on common equity of 10.19%. Without
251 adequate rate relief, returns will continue to fall below Peoples Gas' cost of equity. As
252 shown in Mr. Johnson's testimony, without rate relief Peoples Gas will earn a return on
253 equity of only 0.3% in 2010, based on the financial information presented in this rate
254 case. To repeat, failure to recover costs fully, including earning an adequate return, is not

255 sustainable and results in higher costs for future ratepayers through a higher cost of
256 capital.

257 **III. RIDER PROPOSALS**

258 **A. Rider ICR (Infrastructure Cost Recovery)**

259 Q. Please discuss the need for Rider ICR.

260 A. The Rider ICR proposed in this docket is, consistent with points raised by Staff in the last
261 rate case, based on a comparable mechanism for water and sewer utilities and includes
262 many of the modifications proposed by Commission Staff in that case (conditionally in
263 the event the rider were to be adopted). The rider is modeled after, although not identical
264 to, the infrastructure cost recovery provisions of Part 656 of the Commission's rules
265 relating to water and sewer companies, as is discussed by Ms. Grace. The justification
266 for the Rider ICR in the last rate case is even more critical now. The Commission
267 recognized the need for increasing the pace of infrastructure improvements but believed
268 the case had not been made in sufficient detail or strength to warrant approval of the
269 rider. In response, Peoples Gas hired one of the nation's premier engineering firms,
270 Jacobs Engineering, to do a detailed analysis of the options to replace cast and ductile
271 iron main. The testimony of Mr. Marano will provide his analysis that supports the
272 accelerated replacement of the cast iron and ductile iron main, based on the reduction of
273 future risk to the public, the public good in having a modern asset based gas distribution
274 system, and the economic advantages to an accelerated program.

275 Q. Do current economic conditions affect the need for Rider ICR?

276 A. Most certainly. While we believe that the case for Rider ICR presented in ICC Docket
277 No. 07-0242 was and is compelling, especially as further buttressed by the testimony of

278 Mr. Marano, the economic events of the past year have added another dimension to the
279 need for Rider ICR.

280 First, a key component of the President Obama’s Recovery Plan is an emphasis on
281 infrastructure. The investment in infrastructure is seen as a key to jump starting the
282 economy by creating long-term high paying jobs for skilled workers. The need for
283 “shovel ready” projects is important to the success of this strategy. Accelerating cast iron
284 main replacement in the Peoples Gas system is ideal in that there is a specific program in
285 place to move forward, i.e., it is “shovel ready”, and, given the sustained effort required,
286 will provide long-term employment.

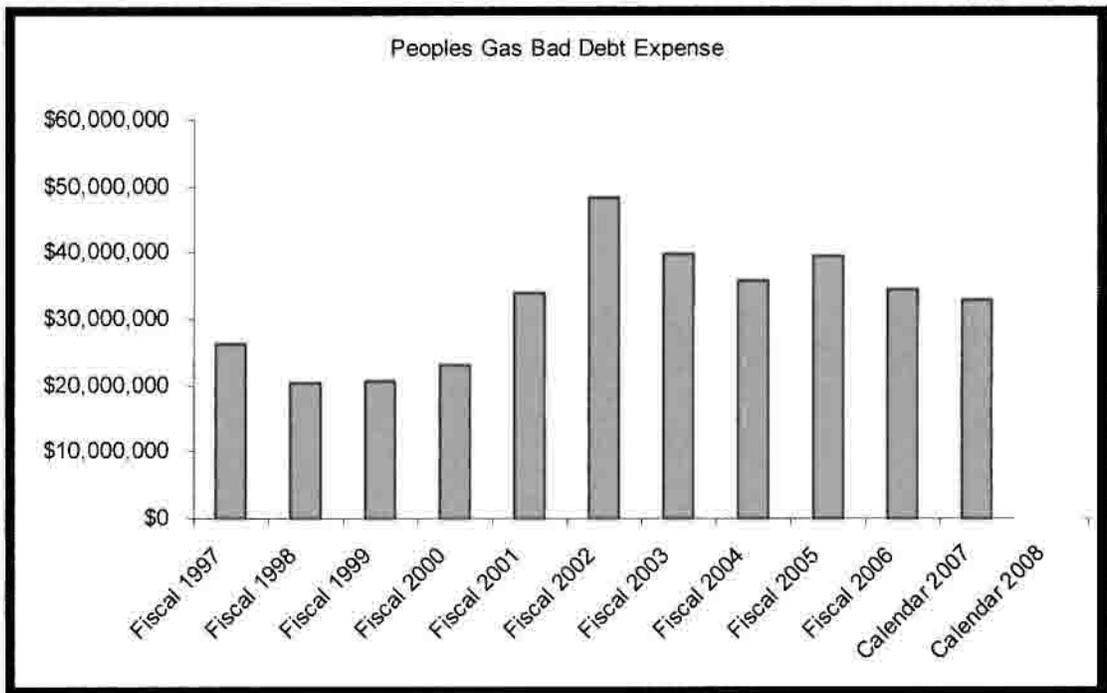
287 Second, as noted in Mr. Johnson’s and Mr. Moul’s testimony, the financial crisis
288 has made capital more expensive to obtain. This makes the need for rider treatment, with
289 the greater level of certainty of recovery on and of the investment in cast iron main, even
290 more critical to keep the capital costs associated with the infrastructure improvement
291 reasonable. Rider treatment also provides assurance to ratepayers that they will only pay
292 for the actual costs of infrastructure in the ground.

293 **B. Rider UEA (Uncollectible Expense Adjustment)**

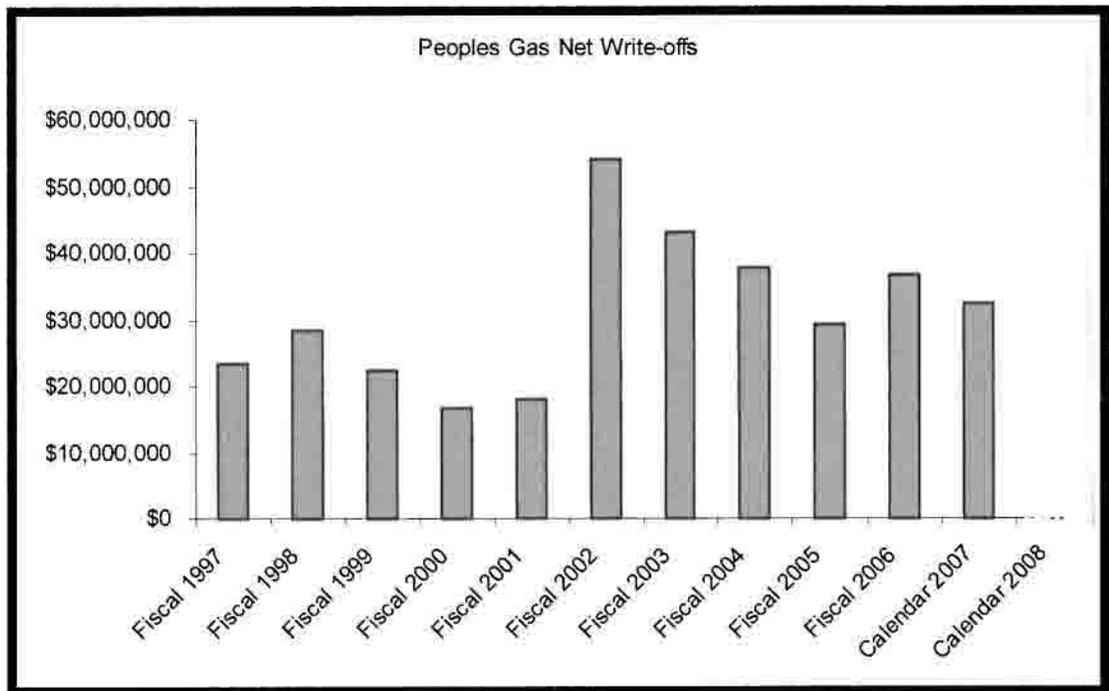
294 Q. Please discuss the need for Rider UEA.

295 [REDACTED] The increased need for an uncollectibles rider like Rider UEA, which applies to sales
296 customers (only) and recovers the gas cost related amounts in Account 904 (Uncollectible
297 Accounts), is driven by volatility in gas costs and the current financial conditions and is
298 especially important given the challenging economic circumstance of the service territory
299 of Peoples Gas. Economic turbulence can exacerbate the volatility and unpredictability
300 of uncollectibles. As noted above, actual calendar 2008 uncollectible expense jumped to

301 [CONF. & PROP.] [END CONF. & PROP.] from \$33.0 million in calendar
 302 2007, an increase of [CONF. & PROP.] [END CONF. & PROP.].
 303 Furthermore, calendar 2008 net write-offs jumped to [CONF. & PROP.]
 304 [END CONF. & PROP.] from \$32.4 million in calendar 2007, an increase of [CONF. &
 305 PROP.] [END CONF. & PROP.]. The tables below further illustrate
 306 the year to year volatility of Peoples Gas' uncollectible expenses and net write offs.
 307 [CONF. & PROP. (AS TO 2008 DATA)]



308
 309



310

311 **END CONF. & PROP.]**

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

313 **IV. RIDER EEP (ENHANCED EFFICIENCY PROGRAM)**

314 Q. Please discuss the status of the Enhanced Efficiency Program for Peoples Gas.

315 A. In ICC Docket No. 07-0742, the Commission authorized Peoples Gas to recover
 316 \$6.4 million annually for the Enhanced Efficiency Program it proposed in the testimony
 317 of Ms. Rukis. Peoples Gas has implemented the program and the Governance Board,
 318 made up of representatives of Peoples Gas, the Attorney General of the State of Illinois,
 319 the City of Chicago, the Citizens Utility Board, and the Environmental Law and Policy
 320 Center, has taken ownership of the program. It has since been rebranded as the
 321 Chicagoland Natural Gas Savings Program.

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

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

329 A. In ICC Docket No. 06-0540 (the “Merger Docket”), Peoples Gas and North Shore
330 indicated they would not file a second rate case with an effective date earlier than
331 January 1, 2010¹.

332 Specifically, in that case, Peoples Gas and North Shore agreed that they would
333 file rate cases in early 2007 based on historical test years (with defined adjustment for
334 merger related synergies and costs to achieve) that would result in rates effective in early
335 2008. Those rate cases have already occurred. Peoples Gas and North Shore further
336 agreed in the Merger Docket they would not file for additional rate increases until 2009 at
337 the earliest, for rates to be effective in 2010. (Order in ICC Docket No. 06-0540,
338 pp. 41-42).

339 Peoples Gas and North Shore reiterate that position in this proceeding. If the
340 Commission did not act during the initial 45 days after the filing (or during the
341 subsequent suspension periods per Section 9-201 of the Public Utilities Act) to suspend
342 the tariffs, because of the aforementioned agreed-upon merger condition, Peoples Gas

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).

343 would not implement any rate increase under this docket prior to January 1, 2010. The
344 effective date provisions of the filed tariffs are consistent with this position.

345 Q. Does this conclude your direct testimony?

346 A. Yes.