STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	**)**	
Proposed General Increase in	**)**	**Docket No. 09-0166**
Rates for Gas Service	**)**	
	)	
THE PEOPLES GAS LIGHT AND COKE COMPANY	**)**	
Proposed general increase in	**)**	**Docket No. 09-0167**
Rates for Gas Service	**)**	

DIRECT TESTIMONY OF DAVID J. EFFRON ON BEHALF OF THE PEOPLE OF THE STATE OF ILLINOIS, THE CITIZENS UTILITY BOARD AND THE CITY OF CHICAGO

AG/CUB/City Exhibit 1.0

JUNE 10, 2009

NORTH SHORE GAS COMPANY
THE PEOPLES GAS LIGHT AND COKE COMPANY
ICC DOCKET NOS. 09-0166, 09-0167
TESTIMONY OF DAVID J. EFFRON
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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty-five years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings and other utility matters?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in numerous cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University.

II. INTRODUCTION AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the People of the State of Illinois represented by the Attorney General ("AG"), the Citizens Utility Board ("CUB") and the City of Chicago ("City").

Q. What is the purpose of your testimony?

A. I am recommending rate base and *pro forma* operating income for the North Shore Gas Company ("NS") and Peoples Gas Light and Coke Company ("PGL") (together "the Companies") in these rate cases, based on the adjustments to the Companies' positions that I have identified in my review and analysis of the Companies' presentations. I have also incorporated the rate of return recommended by CUB witness Mr. Thomas into my calculation of the Companies' revenue deficiencies under present rates. My presentation in this testimony is based on issues that I have identified. I have not reviewed the testimony of Staff or other intervenors in the preparation of this testimony, and I am not taking a position on issues affecting revenue requirements that may be addressed in their testimony at this time. I reserve the right to recommend additional adjustments based upon my review of other parties' testimony.

Q. How is your testimony organized?

A. My testimony is divided into three sections. Section A summarizes my calculation of the Companies' revenue deficiencies. Section B addresses my proposed adjustments to the Companies' test year rate base and is supported by schedules prefixed with "B". Section C addresses my proposed adjustments to the Companies' test year revenues and expenses income and is supported by schedules prefixed with "C".

III. REVENUE REQUIREMENT ISSUES

A. SUMMARY

Q. What revenue deficiency or excess have you calculated for NS and PGL?

A. With regard to NS, based on the test year consisting of the 12 months ended December 31, 2010 I have calculated a rate base of $176,953,000 and *pro forma* operating income under present rates of $5,953,000. Based on the overall rate of return of 7.07% recommended by Mr. Thomas, NS presently has an operating income deficiency of $6,556,000. With a revenue conversion factor of 1.6713, that income deficiency translates into a revenue deficiency of $10,957,000 under present rates. The calculation of this revenue excess is summarized on AG Exhibit 1.1, Schedule A.

With regard to PGL, based on the test year consisting of the 12 months ended December 31, 2010 I have calculated a rate base of $1,190,391,000 and *pro forma* operating income under present rates of $59,219,000. Based on the overall rate of return of 7.36% recommended by Mr. Thomas, PGL presently has an operating income deficiency of $28,370,000. With a revenue conversion factor of 1.7029, that income deficiency translates into a revenue deficiency of $48,311,000 under present rates. The calculation of this revenue deficiency is summarized on AG Exhibit 1.2, Schedule A.

B. RATE BASE

1. UTILITY PLANT

Q. How did the Companies determine the balance of gross utility plant that they are proposing to include in their rate bases?

A. The gross utility plant included in rate base is the forecasted average plant balance in 2010, the test year in this case. The Companies began with the actual balances of plant as of June 30, 2008 and then adjusted those balances for forecasted additions to and retirements from plant for the last six months of 2008 and calendar years 2009 and 2010.

Q. Are you proposing to adjust the test year utility plant included in rate base by the Companies?

A. Yes. First, as the actual balance of plant as of December 31, 2008 is now available, that actual balance should be used as the starting point for the forecast of 2010 test year plant.

Second, and more importantly, in their description of the assumptions used in their forecasts (Part 285, Schedule G-5), the Companies stated that they will "likely reduce" their 2009 capital expenditures in response to the current economic slowdown and may make reductions in 2010 if the current economic environment does not significantly improve. Based on responses to data requests, the Companies have in fact made substantial reductions to their forecasts of capital additions since the time of forecasts on which the rate application are based, and those reductions should be taken into account in the determination of the test year rate bases.

Q. Please describe your proposed adjustment to the gross utility plant included in the PGL rate base.

A. Referring to my Schedule B-1 (PGL), I begin with the actual plant as of December 31, 2008. In response to Staff Data Request PGL MHE 12.01, the Company provided an updated forecast of capital additions in 2009 and 2010. The updated forecast for 2009 is $72,390,000. This is approximately $57 million less than the forecast reflected on Part 285 Schedule B-5, and reduces the forecasted plant balance as of the beginning of the 2010 test year accordingly. I have not modified the forecast of retirements, as the effect of the retirements on plant in service are exactly offset by a corresponding charge to deprecation reserve, with no net effect on rate base.

The updated forecast of plant additions in 2010 in the response to Staff Data Request PGL MHE 12.01 is $80,129,000. This is approximately $103 million less than the forecast reflected on Part 285 Schedule B-5, and reduces the forecasted plant balance as of the end of the 2010 test year accordingly. Again, I have not modified the forecast of retirements in 2010 in my calculation of the plant as of the end of 2010.

With these modifications to the forecast of plant additions in 2009 and 2010, the average balance of gross utility plant in the 2010 test year is $2,549,045,000. This is $116,343,000 less than the gross utility plant included in rate base by PGL.

Q. Please describe your proposed adjustment to the gross utility plant included in the NS rate base.

A. Referring to my Schedule B-1 (NS), I again begin with the actual plant as of December 31, 2008. In response to Staff Data Request NS MHE 12.01, the Company provided an updated forecast of capital additions in 2009 and 2010. The updated forecast for 2009 is $9,638,000. This is approximately $5.0 million less than the forecast reflected on Part 285 Schedule B-5, and reduces the forecasted plant balance as of the beginning of the 2010 test year accordingly. As with PGL, I have not modified the forecast of retirements.

The updated forecast of plant additions in 2010 in the response to Staff Data Request NS MHE 12.01 is $10,154,000. This is also approximately $5.0 million less than the forecast reflected on Part 285 Schedule B-5, and reduces the forecasted plant balance as of the end of the 2010 test year accordingly. Again, I have not modified the forecast of retirements in 2010.

With these modifications to the forecast of plant additions in 2009 and 2010, the average balance of gross utility plant in the 2010 test year is $393,430,000. This is $5,374,000 less than the gross utility plant included in rate base by NS.

2. RESERVE FOR ACCUMULATED DEPRECIATION

Q. Are you proposing any adjustments to the reserve for accumulated depreciation?

A. Yes. First, as with the plant, the actual balance of depreciation reserve as of December 31, 2008 is now available, and that actual balance should be used as the starting point for the forecast of 2010 test year depreciation reserve. Second, the forecast of deprecation reserve for the 2010 test year should be modified to reflect the adjustments to the plant additions in 2009 and 2010. On my Schedules B-1, I have calculated adjustments to reduce the PGL 2010 test year depreciation reserve by $9,830,000 and the NS 2010 test year depreciation reserve by $919,000.

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3. CASH WORKING CAPITAL

Q. How did the Companies determine the cash working capital allowance that they include in their rate base?

A. The calculation of the Companies' working capital allowances are summarized on their Schedules B-8. The cash working capital allowances are based on lead-lag studies, which measure the cash requirement to bridge the gap between the disbursement of cash to pay expenses and the receipt of cash for service rendered to cover those expenses.

Q. Are you proposing to adjust the cash working capital requirements calculated by the Companies?

A. Yes. The largest expense in the lead lag study is the cost of gas. I am not proposing to modify the net lag assigned to the cost of gas expense. However as noted by the Companies on Part 285, Schedule G-5, the forecasted test year purchased gas costs were based on the one day forward NYMEX gas price as of June 25, 2008, which was $10.95 per MMBtu. The price of gas has come down significantly since then, and the Companies have updated the forecasted 2010 test year purchased gas costs. The cost of gas in the lead-lag studies should be modified to incorporate the Companies' updates.

The PGL forecasted test year cost of gas based on the June 28, 2008 NYMEX price of $10.95 was $1,167,228,000. In response to Staff Data Request PGL ENG 3.03, PGL stated that the current forecast of test year purchased gas cost is $611,700,000. Modifying the cost of gas in the lead-lag study to reflect the current forecast reduces the PGL cash working capital allowance by $14,779,000 (my Schedule B-2).

The NS forecasted test year cost of gas based on the June 28, 2008 NYMEX price of $10.95 was $268,987,000. In response to Staff Data Request NS ENG 3.03, NS stated that the current forecast of test year purchased gas cost is $149,300,000. Modifying the cost of gas in the lead-lag study to reflect the current forecast reduces the NS cash working capital allowance by $134,000 (my Schedule B-2).

4. GAS IN STORAGE

Q. Are you proposing adjustments to the test year gas in storage inventories included in rate base by the Companies?

A. Yes. The gas in storage inventories are also affected by the forecast of the price of gas in the test year. As with the cash working capital allowance, the test year gas in storage inventories should be modified to reflect the updated forecast of gas prices. However, because of the LIFO method of accounting used by the Companies, the forecast of 2010 gas prices affects the balances for only a few months in the test year, and thus the update has a relatively limited effect on the average balance of gas inventory over the year. I have calculated that reflecting the current forecast of prices reduces the PGL test year average balance of gas in storage inventory by $1,190,000 and the NS test year average balance of gas in storage inventory by $999,000 (my Schedules B-1).

5. RETIREMENT BENEFITS, NET

Q. What do the "Retirement Benefits, Net" included in rate base by the Companies represent?

A. The "Retirement Benefits, Net" consists of two components. The first is prepaid pensions (PGL) or the accrued liability for pension costs (NS). The prepaid pension is mainly the effect of pension income recorded by PGL pursuant to Statement of Financial Accounting Standards 87. When the returns generated by the pension investments have been greater than the other elements of the periodic pension costs, pension income (or negative pension expense) is recorded on the books of account. However, no cash is actually withdrawn from the pension funds. Rather, the offset to this non-cash income is a charge to prepaid pensions.

The second component is primarily the accrued liability for future post-retirement benefits other than pensions ("OPEB"), mainly health care costs. Pursuant to Statement of Financial Accounting Standards 106, the Companies must accrue for the payment of future post-retirement benefits other than pensions. To the extent that the accruals are greater than the actual cash disbursements, accrued liabilities will be reflected on the Companies' balance sheets.

PGL offsets the accrued liability for OPEB against prepaid pensions in the calculation of the "Retirement Benefits, Net" that it includes in rate base. NS adds the accrued liabilities for pensions and OPEB together and subtracts that amount from its rate base.

Q. Was this an issue in the Companies last rate cases?

A. Yes. In Docket Nos. 07-0241 and 07-0242, the Companies did not take account of the accrued pension and OPEB balances in the determination of rate base. In response to testimony by Staff and intervenors proposing to deduct the accrued OPEB liabilities from rate base, the Companies stated that if the accrued OPEB liabilities are deducted from rate base, then the prepaid or accrued pension balances should also be recognized.

Q. What was the Commission's finding on this matter in those cases?

A. The Commission in both cases found that the accrued OPEB liability should be deducted from rate base but that the pension balances should not be recognized in the determination of rate base.

Q. How have you treated "Retirement Benefits, Net" in your determination of rate base?

A. Consistent with the Commission's findings in Docket Nos. 07-0241 and 07-0242, I have eliminated the pension balances from rate base, but have treated the accrued liability for postretirement benefits other than pensions as rate base deductions. I have also eliminated the accumulated deferred income taxes related to the prepaid or accrued pensions The net effect of this adjustment is to reduce PGL "Retirement Benefits, Net" by $143,240,000 (AG Exhibit 1.1, Schedule B) and related accumulated deferred income taxes $57,438,000 (AG Exhibit 1.1, Schedule B-3), for a net reduction to the PGL rate base of $85,802,000.

With regard to NS, the effect of my proposed adjustment is to reduce the rate base deduction for "Retirement Benefits, Net" by $3,022,000 (AG Exhibit 1.1, Schedule B) and to increase the related accumulated deferred income taxes by $228,000 (AG Exhibit 1.1, Schedule B-3), for a net increase to the NS rate base of $3,250,000.

6. ACCUMULATED DEFERRED INCOME TAXES

Q. Are you proposing any adjustments to the balance of accumulated deferred income taxes ("ADIT") deducted from gross utility plant in the determination of rate base?

A. Yes. ADIT represents the cumulative effect of book-tax timing differences, such as the deferred tax liability associated with the excess of tax accelerated depreciation over book depreciation.

Consistent with my proposed modifications to plant additions, I am also modifying the related balances of ADIT. This adjustment is shown on my Schedule B-3 and reflects the reduction to the balance of ADIT associated with my proposed reductions to plant additions. I have also adjusted the accumulated deferred income tax balance to remove the deferred taxes on the pension asset or liability in association with my proposed rate base adjustments to the accrued pension balances. This adjustment to ADIT is also on my Schedule B-3.

C. OPERATING INCOME

1. REVENUE

Q. Have you analyzed the Companies' forecasts of 2010 test year sales and revenues?

A. Yes. The forecasts of test year sales and revenues are summarized on Part 285 Schedule E-5, and described in Exhibit DWC-1.0

Q. Are you proposing to update the Companies' forecasts of 2010 test year sales and revenues?

A. Yes. The sales forecasts are sensitive to the projected cost of gas. The current forecast of the 2010 price of gas is significantly lower than the projected prices at the time the sales forecasts were originally prepared. Therefore, the sales forecasts should be modified to reflect the current forecast of 2010 gas prices.

Q. Please describe how you propose to modify the forecasts of test year sales to reflect the current forecast of 2010 gas prices.

A. In response to Data Requests PGL AG 3.48 and NS AG 3.90, the Companies provided revised forecasts of 2010 sales assuming a NYMEX gas price of $6.52 per MMBtu, which was the alternative price referenced in Part 285 Schedule G-5. In response to Staff Data Requests PGL ENG 3.02 and NS ENG 3.02, the Companies provided an updated forecast for the 2010 price of gas of $6.06 per MMBtu (including the Chicago basis spread). I have extrapolated the sales adjustments in the responses to Data Requests PGL AG 3.48 and NS AG 3.90 to calculate the effect on 2010 sales of incorporating a gas price of $6.06 per MMBtu.

Q. Please explain results of your calculations.

A. The results of my calculations are shown on my Schedule C-1. I have calculated that reflecting a gas price of $6.06 per MMBtu would increase the forecasted PGL Rate 1 sales by 15,671,000 therms and Rate 2 sales by 9,650,000 therms. The increase in therm sales to these rate classes result in an increase to test year base revenues under present rates of $4,344,000.

With regard to NS, I have calculated that reflecting a gas price of $6.06 per MMBtu would increase the forecasted NS Rate 1 sales by 2,911,000 therms and Rate 2 sales by 3,373,000 therms. The increase in therm sales to these rate classes result in an increase to test year base revenues under present rates of $559,000.

These increases to therm sales should be reflected in both the determination of *pro forma* operating income under present rates and the calculation of rates necessary to produce the Companies' calculated revenue requirements.

2. OPERATION AND MAINTENANCE EXPENSE

Q. How are the *pro forma* operation and maintenance expenses included in the Companies' revenue requirements determined?

A. The forecasted operation and maintenance expenses for the test year ended December 31, 2010 are the starting point. Those forecasted expenses are then adjusted to reflect Commission ratemaking policy, to incorporate the effect of certain changes, and to eliminate any abnormal or non-recurring items. The intent is to include expenses reflecting normal operations in the determination of test year revenue requirements.

Q. Are you proposing adjustments to the *pro forma* operation and maintenance expenses included by the Companies in their determination of adjusted operating income under present rates?

A. Yes. I am proposing adjustments to the *pro forma* operation and maintenance expenses of both Companies. I first address adjustments affecting both companies. I then address certain adjustments that affect only PGL or NS, but not both.

a. Integrys Business Support Charges - Update

Q. Have the Companies modified their forecasts of 2010 test year operation and maintenance expense since the applications were originally filed?

A. Yes. In their description of the assumptions used in their forecasts (Part 285, Schedule G-5), the Companies stated that they will “likely reduce” their 2009 operation and maintenance expenses in response to the current economic slowdown and may make reductions in 2010 if the current economic environment does not significantly improve. Based on responses to data requests, the Companies have in fact made substantial reductions to their forecasts of operation and maintenance expenses, and those reductions should be taken into account in the determination of the test year revenue requirement.

Q. How are you proposing to modify the Companies’ forecasts of test year operation and maintenance expense to incorporate the effect of the reductions?

A. In Staff Data Request PGL DLH 4.06 and NS DLH 4.06, the Companies were asked to provide the adjustments necessary to reflect their undertakings to reduce current and future costs. In response, the Companies provided reductions to test year 2010 operation and maintenance expense for Integrys Business Support

("IBS") charges. The reduction to PGL operation and maintenance expense for IBS changes is $7,493,000, and the reduction to NS operation and maintenance expense for IBS changes is $360,000. I reflect these reductions to forecasted 2010 test year expenses on my Schedule C-2.

b. Payroll

Q. Are you proposing modifications to the forecasted payroll costs included in the Companies' test year operation and maintenance expenses?

A. Yes. I am proposing two adjustments to the Companies forecasts of test year payroll expenses. First, in response to Staff Data Requests PGL DLH 22.01 and NS DLH 22.01, the Companies provided the effect of correcting the forecasted union merit increases to reflect 3.4% increases rather than 4.2% increases. I have incorporated the effect of these corrections, which reduce the PGL payroll expense by $531,000 and NS payroll expense by $70,000 on my Schedule C-2. Second, I am proposing to reduce the Companies' forecasts of the number of employees in the 2010 test year.

Q. Why are you proposing to adjust the Companies' forecasts of the number of employees in 2010?

A. PGL is forecasting that the number of employees in 2010 will be 1139. As of early 2009, the actual number of employees was about 1080, and that number does not appear to be increasing. In the present economic circumstances, I believe that the increase in the number of employees being forecasted by PGL is uncertain.

Similarly, NS is forecasting 170 employees in the 2010 test year. This is an increase over the 167 employees in the early months of 2009, which, like the PGL employee complement, does not appear to be increasing. Therefore, I believe the number of test year employees and the payroll expense forecasted by PGL and NS should be modified.

Q. How are you proposing to adjust the forecasted 2010 test year payroll expense?

A. Based on the response to Data Requests PGL AG 3.18 and PGL AG 3.19, the actual number of PGL employees in the last half of 2008 and the first three months of 2009 was relatively steady at about 1,080 (although the actual number of employees in March 2009, the last month shown was slightly lower at 1,075). I recommend that the PGL 2010 test year payroll expense be adjusted to reflect 1,080 employees rather than the PGL forecast of 1,139.

Based on the response to Data Requests NS AG 3.64 and NS AG 3.65, the actual number of NS employees in the last half of 2008 and the first three months of 2009 was relatively steady at about 167 (the exact number from September 2008 through March 2009). I recommend that the NS 2010 test year payroll expense be adjusted to reflect 167 employees rather than the NS forecast of 170.

Q. What is the effect of your proposed adjustments to the forecasted number of employees in the 2010 test year?

A. My proposed adjustment to the PGL test year employee complement reduces the forecasted test year operation and maintenance expense by $2,987,000. My proposed adjustment to the NS test year employee complement reduces the forecasted test year operation and maintenance expense by $137,000 (my Schedule C-2.1).

c. Incentive Compensation

Q. What is your understanding of the Commission's general practice with regard to the inclusion of incentive compensation expense in the revenue requirements of regulated utility companies?

A. It is my understanding that in recent cases the Commission has generally allowed the recovery of incentive compensation only when it is demonstrated that such compensation operates so as to benefit the utility's customers, rather than operating solely for the benefit of shareholders. (See, for example, Docket Nos. 07-0241/07-0242, Peoples Gas Light and Coke Company and North Shore Gas Company.)

Q. What amounts of incentive compensation have the Companies included in test year operation and maintenance expenses?

A. PGL includes $5,620,000 of incentive compensation in 2010 test year operation and maintenance expenses (response to PGL DLH 1.04), and NS includes $1,072,000 of incentive compensation in 2010 test year operation and maintenance expenses (response to NS DLH 1.04).

Q. Is all of this incentive compensation expense properly recoverable from ratepayers?

A. No. Unless the Company can demonstrate that the goals employees are expected to achieve would benefit ratepayers, the incentive compensation related to those goals should not be recoverable from ratepayers. The achievement of goals such as quality of service, reliability, public safety, reducing absenteeism, and cost containment are at least arguably in the interest of ratepayers. However incentive compensation based on financial goals such as maximizing profitability and growth, increasing earnings per share, or increasing return on equity is beneficial only to shareholders, and not properly recoverable from ratepayers. For example, if all else is equal, higher rates will result in higher revenues, which in turn will result in higher earnings and return on equity. Thus, including incentive compensation related to such goals in the revenue requirement would, in effect, require customers to reward utility management on a contingency basis for getting them to pay higher rates. If the incentive compensation program is successful in increasing earnings, the shareholders should be happy to reward management accordingly and absorb the cost of the program. As shareholders are the primary beneficiaries of the attainment of financial goals such as increases to earnings and return on equity, it should be those shareholders, not customers, who bear the cost of the incentive compensation related to the achievement of such financial goals

The incentive compensation included in test year operation and maintenance expense by the Companies includes compensation paid directly to employees of the Companies and compensation allocated from affiliates, including

IBS. Of the incentive compensation paid directly to employees of the Companies, 50% relates to operational goals, such as customer satisfaction and safety, and 50% relates to net income, which is a shareholder goal. With regard to the incentive compensation allocated from affiliates, as far as I can determine, 100% relates to shareholder-oriented financial goals.

Q. What do you recommend?

A. Based on my review of the Companies' incentive compensation, 50% of the incentive compensation paid directly to employees of the Companies and 100% of the incentive compensation allocated from affiliates should be eliminated from the incentive compensation included in the Companies' revenue requirements. These adjustments result in a $4,567,000 reduction to PGL test year operation and maintenance expense and a $944,000 reduction to NS test year operation and maintenance expense (my Schedule C-2).

d. Uncollectible Accounts Expense

Q. Should the uncollectible accounts expenses included in the Companies' revenue requirements be adjusted?

A. Yes. The uncollectible accounts expense is calculated by applying the net write-off rate to total revenues, including gas charge revenues. I am proposing two adjustments to uncollectible accounts expense. First, as I am proposing to increase forecasted test year sales and revenues, I reflect an increase to uncollectible accounts expense related to those increases in revenues.

Second, as noted above, the forecasted test year purchased gas costs were based on the one day forward NYMEX gas price as of June 25, 2008, which was $10.95 per MMBtu., but the price of gas has come down significantly since that time, and the Companies have updated the forecasted 2010 test year purchased gas costs. The gas cost revenues reflected in the calculation of test year uncollectible accounts expense should be modified to incorporate the Companies' updates.

Q. What is the effect of your proposed adjustments to test year uncollectible accounts expenses?

A. The effect on uncollectible accounts expense of the decreases to gas cost revenues identified in the responses to Staff Data Requests PGL ENG 3.03 and NS ENG 3.03 is significantly greater than the effect of my proposed sales increases. The net effect is to reduce the PGL uncollectible accounts expense by $13,713,000 and the NS uncollectible accounts expense by $850,000 (my Schedule C-2).

e. Savings Plan Expense

Q. Have you analyzed the forecasted test year employee benefits expenses?

A. Yes. The test year employee benefits are summarized on the Companies' Part 285 Schedules C-11.3.

Q. Are you proposing any adjustments to the Companies test year employee benefits expenses?

A. Yes. One of the elements of employee benefits is the "Savings and Investment Plan." Part 285 Schedule 11.3, Page 4 shows the cost of the savings plan being charged entirely to expense. In the responses to Data Requests PGL AG 3.21 and NS AG 3.67, the Companies stated the failure to capitalize a portion of the savings plan cost was in error and that in fact a portion of the costs will be capitalized. I have adjusted the savings plan costs included in test year operation and maintenance expense based on the percentage of direct payroll costs charged to operation and maintenance expense. The adjustments result in a reduction of $867,000 to PGL test year operation and maintenance expense and a reduction of $145,000 to NS test year operation and maintenance expense (my Schedule C-2).

f. Company Use Gas

Q. Should the cost of company use gas included is forecasted 2010 test year operation and maintenance expenses be adjusted?

A. Yes. Based on the response to Staff Data Request PGL DLH 7.06, the 2009 reforecast of the price of gas results in a reduction to cost of company use gas from $6,237,000 to $5,013,000, a decrease of $1,224,000. I have reduced forecasted test year operation and maintenance expense by this amount on my PGL Schedule C-2.

According to the response to Staff Data Request NS DLH 7.06, NS inadvertently omitted the cost of company use gas from 2010 test year expenses, but that based on the 2009 reforecast of the price of gas, the cost of company use gas would be $137,000. I have reflected this expense on my NS Schedule C-2.

g. IBS G&A Billings

Q. What do the IBS Billings for G&A and Cross Charges included in Account 930.2 (Part 285, Schedule C-21) represent?

A. These charges represent mainly carrying charges and depreciation on IBS hardware and software systems that are allocated to PGL and NS.

Q. Are you proposing to modify the amounts of these charges included in pro forma test year operation and maintenance expenses?

A. Yes. The total depreciation expense (before allocation) on the IBS mainframe server in 2010 is $7,953,000. However, as of the end of 2010, the net remaining book value of the mainframe server will be only $544,000. Thus the mainframe server will be completely depreciated in early 2011. In effect, if the rates established in this case are in effect for more than one year, those rates will continue to reflect depreciation on the IBS main frame server even after that plant has been completely depreciated. Therefore, the test year depreciation expense on the IBS mainframe server should be modified.

Q. What do you recommend?

A. The Companies are proposing to amortize the costs of this rate case over three years, reflecting an implicit assumption that the rates in this case will be in effect for three years. I believe that this is a reasonable assumption for the purpose of amortizing the remaining costs of the IBS mainframe server. Therefore, I propose to amortize the remaining net book value of the mainframe server as of the beginning of the 2010 test year over three years.

Amortization of the IBS mainframe server over three years reduces the annual depreciation expense by $5,121,000. After allocation, this modification results in a reduction of $1,610,000 to PGL test year operation and maintenance expense and a reduction of $274,000 to NS test year operation and maintenance expense (my Schedule C-2).

h. Regulatory Expense

Q. Are you proposing to adjust the PGL 2010 test year regulatory expense?

A. Yes. I am proposing two adjustments. First, in response to Staff Data Request PGL DLH 17.02, PGL stated that $540,000 of costs related to fees for consultants in Docket No. 06-0311 were inadvertently included in test year operation and maintenance expenses. PGL acknowledges that these expenses should be excluded, and I have eliminated them on my Schedule C-2. Second, in its response to Staff Data Request PGL BAP 3.03, PGL indicated that the 2010 test year expense include $1,100,000 for outside professional services for rate case support. I am proposing to eliminate this expense.

Q. Why should the cost of rate case support be eliminated from pro forma test year operation and maintenance expenses?

A. In its Adjustment C-2.1, PGL increases test year expenses to reflect the amortization of rate case costs over three years. Amortizing rate case costs and also treating rate case costs as a current test year expense is a double counting of those costs. Therefore, I have eliminated $1,100,000 of rate case costs from test year operation and maintenance expense on my PGL Schedule C-2.

i. Franchise Requirements

Q. What does the franchise requirements expense included by NS in 2010 test year operation and maintenance expenses represent?

A. The franchise requirements expense represents the value of gas provided to municipalities under franchise agreements. NS includes franchise requirements expense of $1,939,000 in 2010 test year operation and maintenance expenses.

Q. Should the franchise requirements expense included in test year operating expenses be adjusted?

A. Yes. Based on the response to Staff Data Request NS ENG 3.04, the corrected 2009 reforecast of the price of gas results in revised test year franchise gas costs of $1,092,000, which is $847,000 less than the amount originally included in 2010 test year expenses. Accordingly, I have reduced forecasted test year operation and maintenance expense by $847,000 on my NS Schedule C-2.

3. DEPRECIATION EXPENSE

Q. Are you proposing any adjustments to *pro forma* test year depreciation expense?

A. Yes. I have proposed to modify the balance of utility plant included in rate base. The *pro forma* depreciation expense is based on the *pro forma* balance of plant in service. Therefore, the depreciation expense included in the cost of service should be modified to reflect the adjustment to plant in service. On my Schedule C-3, I have calculated an adjustment to reduce the PGL depreciation expense by $2,702,000 and the NS depreciation expense by $150,000.

4. TAXES OTHER THAN INCOME TAXES

Q. Are you reflecting any adjustments to taxes other than income taxes in your calculation of *pro forma* operating income?

A. Yes. I have proposed certain adjustments to test year wages and salaries. Consistent with those adjustments, I am also eliminating the payroll taxes on those wages and salaries. The adjustment to taxes other than income taxes is shown on my Schedule C-4.

. I am also proposing to modify the *pro forma* invested capital tax expense included in the Companies' revenue requirement. The Companies have adjusted the invested capital tax to recognize the increased operating income that will result from the increased rates that they are proposing in these cases. I have modified the *pro forma* adjustment to invested capital taxes to reflect the reduced increase to operating income that I have calculated. This adjustment is also shown on my Schedule C-4.

5. INCOME TAX EXPENSE

Q. Please explain your adjustment to income tax expense.

A. The calculation of my adjustment to income tax expense is shown on my Schedule C-5. This schedule shows the adjustments to taxable income from the other adjustments to operating income that I am proposing. I also calculate the adjustment to interest expense (the weighted cost of debt times rate base) resulting from my proposed adjustments to rate base and the capital structure and cost of equity proposed by Mr. Thomas. I apply the state income tax rate to the adjustments to taxable income to calculate the adjustment to state income tax expense, and apply the federal income tax rate to the adjustments to taxable income net of state income taxes to calculate the adjustment to federal income tax expense.

Q. Does this conclude your direct testimony?

A. Yes.